Group of Thirty

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RESERVE ASSETS AND A SUBSTITUTION ACCOUNT

Towards a Less Unstable International Monetary System

by

The Reserve Assets Study Group of the
Group of Thirty

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STATEMENT BY DR. H. JOHANNES WITTEVEEN
Chairman of the Group of Thirty

In a growing world economy, where economic and financial strength is more and more widely shared, the monetary system, based almost exclusively on one currency, the dollar, must naturally come under increasing strains. These strains, which will be aggravated by the continuing large payments surplus of OPEC countries now in prospect, have recently shown themselves in a tendency of many central banks around the world to 'diversify' the composition of their reserves. A so-called 'multi-currency reserve system' is developing.

Differing views may be held about the response (if any) that the international community should make to these developments. I and my colleagues in the Group of Thirty are of the opinion that if the process were left entirely to the interplay of market forces and the uncoordinated policies of individual central banks, the road ahead would indeed be a bumpy one for the world economy. A multiple currency reserve system is inherently unstable. Shifts in currency preferences of central banks would be an additional destabilizing element in foreign exchange markets. They would thus tend to increase fluctuations in exchange rates. Given the risks that these fluctuations would entail for trade, investment and employment, we believe that a cooperative approach to the problem is urgently required.

That is why we have chosen the subject "Reserve Assets and a Substitution Account" for the first of the policy statements which we plan to issue from time to time. The report that follows outlines some suggestions on how the world's financial community might respond to the challenge. In the first place, it gives strong support to the proposal, on which important official discussions are being held, for the establishment of a Substitution Account in the International Monetary Fund. In addition, it suggests the development—as a complement to the Substitution Account—of forms of cooperation between central banks which would guide their policies to a less destabilizing pattern.

None of these suggestions will solve all the problems of the monetary system. There is no panacea. But they would help. They would at least take away some additional elements of instability and would move monetary arrangements in the direction of the aims which the international community has set for itself in the amended Articles of Agreement of the I.M.F.

The report has been drafted by the Reserve Assets Study Group of the Group of Thirty, and discussed by the full Group; these discussions were in turn taken into account in the final report. Nevertheless, many members of the Group of Thirty hold official positions and cannot for obvious reasons be held responsible for all the views expressed in the report. Members of the Group of Thirty participate in its meetings in a personal capacity and our reports and policy recommendations should not in any respect be taken to represent the views of institutions with which members are associated.

H. Johannes Witteveen
February, 1980

Towards a Less Unstable International Monetary System

It is clear, in the opinion of the Study Group, that there is a serious reserve asset problem in today's international monetary arrangements. In particular, it is unlikely that the dollar can continue indefinitely to provide some 80 percent of the world's foreign exchange reserves. It may be felt that it is inappropriate for any national currency to play this central role and that efforts should be made over the longer term to establish the primacy of an international reserve asset; or it may be felt that there is a disequilibrium in the existing pattern of reserve holdings which can only be satisfied over time with the growth of other national currencies as reserve assets; or, even if neither of these long-run aims is subscribed to, it may be felt that the present situation leads to avoidable instability in foreign exchange markets.

This report sets out the conclusions of the Study Group of the Group of Thirty which has been considering these questions over the past few months. Members both of the Study Group and of the Group of Thirty participate in their meetings in a personal capacity and the present report should not be construed as reflecting the views of the institutions with which members are associated.

The report is divided into the following sections:

(a) The trend towards diversification of currency reserves;

(b) An SDR Substitution Account;

(c) The role of the private sector;

(d) Possible supplementary or alternative arrangements;

(e) Conclusion.

The Trend Towards Diversification

Aggregate estimates suggest that since 1970 central banks have moved out of sterling and into Deutschemarks and other non-dollar currencies but that there has been no net diversification out of the dollar, since the proportion of dollar holdings in total currency reserves has remained remarkably stable, at around 80 percent. However, the country composition of reserves shows that a number of groups of countries have reduced the proportion of dollars in their reserves, with some showing reductions in the absolute levels of their dollar holdings. If the five "reserve currency" countries (defined to include France, Germany, Japan, Switzerland and the United Kingdom) are excluded, the dollar proportion of the foreign exchange reserves of the remaining 76 countries covered in estimates prepared for the Group fell from 71.7 percent at December, 1970 to 67.0 percent at September, 1978. The increase in the dollar proportion of the "reserve currency" countries (from 91.3 percent to 93.3 percent over the same period) probably stemmed less from deliberate attempts to increase the total, or change the composition, of their reserves, than from active intervention in foreign exchange markets designed to affect their exchange rates. The dollar proportion of the reserves of several developing countries has fallen sharply. In addition, there is evidence that diversification by certain groups of countries assumed significant proportions towards the latter part of the period. Finally, official or quasi-official institutions other than central banks in some countries may have diversified on a larger scale than is suggested by the figures, which are based on holdings of central banks.

The weakness of the U.S. balance of payments has been one important factor in this trend towards diversification. Anticipations of a fall in the value of the dollar naturally create an incentive to diversify into other currencies, as do expectations of continued volatility in exchange rate movements. However, it is unlikely that an improvement in the U.S. balance of payments, as has occurred over the past year, can be expected to bring about a complete and sustained reversal of the process. Many factors other than the state of the U.S. current account or the outlook for the dollar are likely to influence portfolio decisions by central bankers. These include not only the changing composition of world trade but also the increasing sophistication of the foreign exchange management of many central banks, particularly in the developing world; the desire to purchase foreign currency assets matching the expected pattern of foreign currency expenditures on large-scale projects, again particularly in the developing world; the comparable desire to purchase assets to match interest and principal payments on international borrowing, such as borrowing in the Eurobond or Eurocredit markets, denominated in non-dollar currencies; and the disappearance of the remaining inhibitions against using the Eurocurrency markets as means of diversifying into the currencies of those countries which do not wish to encourage the reserve-currency role of their national currencies.

Exchange rates may be influenced as much by anticipated as by actual diversification. While it may be questioned how far, if at all, the existing proportion of dollar holdings represents in aggregate "involuntary" accumulations, there can be little doubt that some large dollar holders have felt "locked in" in the sense that they believed dollar sales would adversely affect the values of their portfolios, i.e. their dollar holdings are believed to be too large for risk diversification. The desire for reserve diversification by some "reserve currency" central banks, which have in total increased the dollar proportion of their reserves, may also be significantly greater than the figures suggest, for reasons noted above.

The actual or potentially destabilizing effects of currency diversification are increased if, as is probable, central banks attempt (or are believed in the markets to desire) to change their portfolio mix at the margin at times of pressure on the dollar. In particular, such attempts, or market expectations of such attempts, may precipitate much larger private sales of the principal reserve currency, as was experienced at times during sterling's decline as a reserve currency. Expectations of both official and private sales may in turn trigger violent exchange-rate movements affecting the whole structure of the world's currency and trading arrangements.

The Study Group concluded that the pressures making for a greater degree of currency diversification by official and private holders were likely to persist; and that a system which relied on one national currency for the bulk of its currency reserves was likely, for that reason as well as others, to continue to experience large-scale, unpredictable and often destabilizing capital flows. At the same time, the internationalization of the banking systems of many countries, and in particular the gradual opening-up of the financial markets of some potential reserve-currency centers, would not only facilitate the emergence of currencies other than the dollar as reserve currencies but also in our view further increase the potentiality, unless accompanying measures were taken (see below), of such unpredictable large-scale capital flows. These flows would, however, be even less subject to control if holdings of non-dollar currencies continue to be diverted, as hitherto, largely to the Eurocurrency markets.

Although it is widely accepted that there is some unfulfilled desire on the part of official holders throughout the world to diversify somewhat out of dollars and into other currencies, a consensus has not yet developed as to the most appropriate means of meeting this demand. What is clear is that both existing and potential reserve centers are reluctant to promote the development of a multicurrency reserve system (MRS). This is understandable. First, both **a priori** analysis and the evidence from situations where bimetallism has prevailed in the past indicate the potential instability of any system based on more than one reserve asset. Secondly, the post-war years have highlighted the difficulties that can beset a mature reserve currency center if its performance is considered unsatisfactory. Thirdly, the exposure of a reserve center to large and sometimes sudden changes in the volume of externally-held short-term claims upon it can greatly complicate the operation of its domestic monetary policy. Fourthly, a decision to establish and operate new reserve currencies would be likely, unless very carefully handled, to have destabilizing effects on existing reserve currency centers and on major exchange rate relationships.

In the light of such considerations, and especially the intrinsic difficulty of managing a multi-currency system, the Group concluded that a major effort should be made to reach international agreement on a Substitution Account issuing claims denominated in SDRs.* The need to establish a Substitution Account is lent added urgency by the prospect that OPEC countries are likely to run a substantial aggregate current account surplus for a number of years. At the same time, recognizing that the trends towards currency diversification noted above are likely to continue over the next few years, the Group also considered possible ways in which the official international community might handle such pressures so as to minimize any disturbance or disruption they might cause while an SDR Substitution Account was being established and developed.

An SDR Substitution Account

A Substitution Account should serve the objectives both of promoting the use of the SDR as a reserve asset and of offering an alternative to the further diversification of currency reserves. A successful Substitution Account would therefore contribute to exchange rate stability, while in the long term it would also facilitate an orderly reduc-

*SDRs (Special Drawing Rights) are reserve assets issued by the International Monetary Fund. Their value in terms of the U.S. dollar is determined as the sum of the dollar values, based on market exchange rates, of specified quantities of 16 currencies.

tion in the reserve currency role of the dollar. An additional objective has occasionally been mentioned in this context—that of preventing renewed accumulations of dollars in national reserves. According to this view, agreement on the creation of a Substitution Account should be accompanied by an agreement to restrict further official accumulations of dollars. This would constitute, however, a large step towards what is referred to as "mandatory asset settlement" and would be impractical at the present time. It is, of course, possible that in the long run the international community may show itself prepared to make the important moves to an SDR-standard and a wider role for the SDR in official intervention in the foreign exchange market. The latter possibility points, in turn, even at this stage towards the desirability of promoting the use of the SDR and of SDR-denominated claims in the private market. However, the Group regards the role of an SDR Substitution Account at the present time as being essentially complementary to the range of existing reserve assets and to other steps that should be taken to improve the functioning of the system.

The basic framework of a Substitution Account might be as follows: participants would deposit foreign exchange (initially dollars) in an Account administered by the IMF, in return for SDR-denominated claims or 'certificates'; the managers of the Account would invest the funds in securities or other assets denominated in dollars; the Account would pay interest on the SDR claims and various arrangements would be made to ensure the full usability of the claims as reserve assets. There are, however, numerous questions and problems that have to be resolved in setting up an Account and we return to some of these below.

There are certain general principles and considerations that in the view of the Group should be followed for the scheme to make a worthwhile contribution:

(i) Participation should be voluntary.

(ii) Wide participation is essential.

(iii) The size of the Account should be significant in relation to existing foreign exchange holdings in the form of dollars. These totalled some SDR 150 billion as of June, 1979, but a sizable proportion is unlikely to be subject to diversification pressure; thus an account that amounted after a time to some SDR 50 billion would make an important contribution.

(iv) The scheme should be market-oriented, providing incentives for private-sector institutions to hold, and develop markets in, SDR-denominated claims.

(v) For all these reasons, the claims or certificates to be issued by the Account should be sufficiently attractive.

(It should be noted that substitution, which would not change the stock of reserves, should not be regarded as an alternative to the creation of SDRs by allocation).

The most important determinants of the attractiveness of the proposed SDR claim on the Substitution Account will be its yield and liquidity characteristics:

(i) Interest on the claims should be paid at a rate closely related to a weighted average of short-term rates prevailing in the major financial markets. It should be adjusted regularly, for example every three months. This aspect of our proposal is discussed further in the following section.

(ii) Interest could be paid either in dollars or in the form of additional SDR claims; one advantage of the latter method would be that the size of the Account would grow naturally over time.

(iii) Claims should be freely transferable between official participants, by mutual agreement.

(iv) Claims should also be freely transferable between official and private holders. This would enhance the liquidity of these claims, encourage their use by the private sector, and open the way to the eventual private use of SDRs proper (which cannot be held privately at present). However, private holders of dollars should not be permitted, at least initially, to deposit them with the Account, as this would unduly complicate its administration.

(v) We hope that over time a main way in which countries could obtain liquidity for their claims would be through the market; and if, as is suggested in (i) above, interest were paid at a market-related rate, the claims could be traded in a secondary market at or close to par. Initially, however, there would be a need for some official mechanism on which participants could rely, for selling their SDR claims in exchange for currencies, in case of balance-of-payments need; i.e. use of acceptance/designation rules such as those employed to transfer SDRs proper and, beyond this, if necessary, encashment of the claims at par at the Account (i.e. participants would receive the dollar equivalent of the face-value of the SDR claim, at the $-SDR rate prevailing on the day of the transaction). The United States, though not a depositor, could also have an acceptance obligation; this would further enhance the liquidity of the scheme. We would hope that the need for, and the role of, this kind of mechanism would rapidly decline as the private market in SDR claims developed.

(vi) The SDR claim should be of indefinite maturity because substitution should be regarded as permanent.

It is the opinion of the Group that an Account issuing a claim having these characteristics would attract wide participation. Central banks would then gradually become accustomed to holding and using the SDR claim as the internationally respectable reserve asset.

To bring the Account into being, a reasonably large number of IMF member countries would agree to participate for a sufficiently large aggregate amount. Participation by developing countries with appreciable reserves as well as by industrial countries is essential. Subsequently, additional deposits could be made on specific dates both by original and new participants. The dollars deposited would be valued in SDRs on the basis of the $-SDR rate on the day of deposit.

As has been found in market attempts to develop a composite currency unit, such as the SDR, the fundamental problem is that of reaching a combination of interest yield and exchange risk that renders instruments denominated in such units acceptable both to borrowers and to lenders. In the context of the Substitution Account proposal, this problem presents itself in two forms:

First, what arrangements can be made to ensure that the income of the Account will be large enough to cover its interest payments to participants? Second, in the event of liquidation, how would the Account's obligations be settled?

(i) **Interest payments and receipts:**
As already noted, the SDR claim should bear interest at a rate closely related to market rates in the major financial centers.

The rate should be as high as is required to avoid the SDR claim being traded at a significant discount in secondary markets. The precise relationship of the SDR interest rate to other interest rates can only be discovered by experimentation and will certainly change over time, as the markets in these claims develop. We believe the managers of the Account should have discretion to vary the relationship of the rate to market rates from time to time, as they gain experience with private trading in the claim with the objective of avoiding a discount in the market.

How may the Account finance these interest payments? This raises the issues of the investment of the Account's assets and of possible ways of making good an emerging deficiency on interest account if necessary. On the first question, the Account could earn interest on its investments, which would naturally be in dollars, at the US long-term bond rate, and, as long-term rates have on average been higher than short-term rates in the past, it might be expected that this would be sufficient to cover interest payments on its SDR obligations. However, since the interest rate on the SDR claim would be adjusted every three months or so, and short-term rates may from time to time rise above long-term rates, we believe that the managers of the Account should be given a considerable degree of discretion in the conduct of their investment policy. For instance, a case could be made for allowing the managers some discretion to invest also in short-term claims, such as certificates of deposit issued by major banks. Funds might even be placed in the Euromarkets, if there were evidence that funds were being withdrawn on a large scale from the markets as a result of the establishment of the Substitution Account. The difficulty that might otherwise be created for borrowers is this market might be met in this way. This discretion for the managers of the Account would ensure that the interest earnings of the Account were related as closely as possible to its payments on its SDR obligations. At the same time, there would need to be firm safeguards to assure the United States and other countries that such investment would not cause additional complications for the conduct of their financial policies.

However, these approaches would not guarantee that the Account's interest earnings were sufficient in any given year to finance interest payments on SDR claims, given the possibility of changing interest-rate and exchange-rate relationships. Here one possibility would be to cover any deficiency which could not be met out of previously accumulated interest earnings by using some of the dollars in the Account (which transfers this problem to that discussed under (ii) below, as would also be the case if interest were to be credited in the form of additional SDR claims). Another possibility would be for the United States to agree to make a non-interest bearing loan to the Account in any year in which there was such a deficiency, with any surplus being invested in a non-interest bearing deposit in the United States. Yet another possibility, discussed further below, is to use some of the Fund's gold stock to back the Account.

(ii) **Liquidation provisions:**

We do not envisage liquidation of the Account; but some arrangements are necessary if only because the Articles of Agreement of the Fund provide for the liquidation of the SDR Department and indeed of the Fund itself. In this regard one possibility would be a simple risk-sharing arrangement. In the event that the dollar holdings of the Account were insufficient to redeem the dollar value of the SDR claims of participants, half of the additional dollars required might be supplied by the United States, and the other half by participants in proportion to their original participation; an inverse arrangement would be made in the event of a surplus. An alternative that has been proposed is that the Fund might make an allocation of SDRs proper, which would be turned into the Account.

One proposed solution to both aspects of the problem discussed above would be for some of the Fund's gold holdings (worth between $60 billion and $80 billion at the gold price of January, 1980) to be used as backing for the Account. The Account would then take on more of the character of a bank, with command over resources that could be regarded as the equivalent of capital funds, as well as interest earning assets and interest-bearing liabilities. This would have the advantage of making the solvency of the "SDR Bank" dependent on its own assets rather than relying exclusively on the guarantee of the United States and other participants. If, at the same time the managers were able to invest a portion of the dollars with considerable flexibility and were also able to vary the relationship of the interest offered on the SDR claim to market rates, the problem of establishing the attractiveness of the claim to potential diversifiers without asking too large a contribution towards any residual deficit from the United States and other participants could be well on the way to being solved. The United States would of course still be called upon to make a commitment to the scheme and would certainly be a guarantor of the Account.

By thus consolidating a portion of the large short-term liabilities of the United States and placing them in firmer hands the scheme would facilitate in the longer term a gradual reduction in the dollar's reserve currency role. From the point of view of the United States the principal advantage of this would be to alleviate the vulnerability of the dollar and thus the pressure that would otherwise develop for that country to take, in the form of current-account adjustment, all the burden of adjustment to shifts in currency preferences. If the United States were forced to deflate its economy to prevent sales of the dollar by central banks from causing an undue depreciation of the dollar, the growth of US GNP would fall further below its potential growth rate and unemployment would rise further. If on the other hand the US government allowed the depreciation to take its course, inflation would worsen. Both courses would result in unnecessary damage to the US economy. That is why the US government should be prepared to make some contribution to the financial viability of the scheme (though again, we would stress that the United States might well not be called upon in practice to make any higher payments under the scheme than market pressures might otherwise require it to offer, as the recent sharp rise in US interest rates testifies).

In general, participating monetary authorities should not base their decisions on how much of their dollar reserves to deposit in the Account on a narrow view of their self interest, or purely on a search for maximum profits. It should be realized that a cooperative effort is needed, particularly in view of the massive accumulation of reserves by the OPEC countries expected in the coming years. In its evaluation of costs and benefits each country should give proper weight to the desirability, in the common interest, of improving the monetary system and creating greater stability in the exchange markets. We believe that a scheme such as we are suggesting would promote these objectives.

The Role of the Private Sector

The private sector should in time play a major role in promoting the objectives of the scheme. Although the usefulness of the Substitution Account would not depend upon the development of a private market in the SDR claim, it would be greatly improved by such a market. A well-developed market would certainly enhance the liquidity of the scheme, and, more broadly, help to establish the SDR as the internationally respectable reserve asset. It would also lay the foundation for the development in the longer run of an intervention mechanism in SDRs.

It is thus desirable that a secondary market, in which SDR claims are actively traded and valued, be developed as soon as possible. This would assure holders that they can exchange the claims for dollars or any other currency without suffering a significant loss of value, as an alternative to the other courses of action open to them listed on page 80. In this way encashment at the Account, and the use of designation mechanisms that would oblige creditor countries to accept large additional amounts of claims—making participation less attractive for them—would be avoided as far as possible, and the mechanisms themselves gradually phased out.

In order for a secondary market to be established, several conditions have to be satisfied:

(i) The rights of holders of SDR claims other than official depositors should be protected, in the event of the liquidation of the scheme. There should be specific provision ensuring that such holders would have a clear claim on the Fund to receive dollars equivalent to the full face value of their SDR claims (at then current exchange rates); and for the official participants to bear all the loss, if any, from the operation of the Account.

(ii) An efficient clearing mechanism should be established. This could be provided either by the IMF itself or by a commercial bank or group of banks.

(iii) It is important that the yield of the SDR claim be set in a manner that would ensure a good reception by the markets.

It may be impossible, however, to prevent the new SDR claim going to a discount in the secondary market if its yield were to be set in the same way as that of the existing SDR, even if it offered what is referred to as the "full combined rate," which is a weighted average of recent short-term interest rates in the United States, Germany, the United Kingdom, France and Japan. This is because banks and dealers trading the claims would generally base their carrying (or financing) costs on Eurocurrency rates, which are generally higher than domestic interest for comparable terms.

To avoid the emergence of a discount, which could in turn discourage participation in the scheme, we believe that the IMF might consider setting the rate by reference to the average of the Eurocurrency rates of the major currencies. As suggested above, a period of experimentation might be unavoidable, and the managers should be given discretion to alter the formulation on which the rate is based from time to time. We would hope, however, that as the markets developed the yield on the SDR claim would settle into a relationship with that of SDR bank deposits that reflected the official character of the SDR claim. There are various ways in which central banks, in the requirements they place on their commercial banks, might strengthen the official character of the claim.

Another interrelated aspect of the private use of SDRs is the readiness of banks and other commercial institutions to take deposits and make loans denominated in SDRs. At present, the supply of outstanding SDR-denominated deposits and bonds in the international markets is small. Publicly-issued SDR-denominated bonds in the Eurobond market have been modest in total at $250,000,000 and there have been only six issues of such bonds in the last four years.

Although no exact estimate is available on the size of the deposit market, the fact that only about 20 banks are active takers of deposits suggests that total deposits are at most a few hundred million dollars. These SDR-denominated deposits are quite different and distinct in form from that envisaged for use in a future Substitution Account mechanism. They are deposits with a commercial bank in a "composite of currencies" which happens to consist of the same currencies and percentage mix as the SDR. Interest rates quoted for these SDR-denominated deposits are based on rates at which the commercial bank can deploy the individual currencies for the same maturity. These will most likely be the "Euromarket" rates for the major currencies; where there is no Euromarket and domestic investment is prohibited to foreigners the calculated interest rate rate used for that currency will be zero.

In the past, it has been argued that banks have not been willing to take SDR-denominated deposits because there is no forward market in SDRs. As a result, banks would face an open exchange risk because the currency actually deposited and the corresponding asset acquired by the bank would be dollars or another traded currency. However, this point may sometimes be exaggerated. Banks can invest and find forward cover in most of the traded currencies represented in the SDR and, if demand increased, an active market in SDR forwards might be created. The Study Group believes there might be a case for an official institution, such as possibly the Bank for International Settlements, to encourage this development by making a forward market in SDRs.

The critical requirement for the development of a bank deposit market in SDRs, in our opinion, is a source of large-scale investors. If the proposed Substitution Account were launched on a substantial scale, and central banks began using the SDR claims and trading them on secondary markets, commercial banks' awareness of this activity, and participation in it, might encourage them to offer SDR-denominated deposits on a wider scale both to central banks and to private-sector investors.

Once banks accepted SDR-denominated deposits on a substantial scale they could be expected to begin to offer borrowers the option of denominating loans in SDRs and so match their currency book. Syndicated loans denominated in SDRs could become a feature of the banking market. Official institutions, such as the World Bank, might equally be encouraged to issue medium or long-term securities denominated in SDRs.

We recognize that the development of a market in SDR claims and of the use of SDRs as a unit of denomination for private sector financial transactions will be a gradual process. The official scheme should be designed to encourage this process. We consider that a scheme such as we propose would provide incentives to private-sector institutions to develop such markets.

Possible Supplementary or Alternative Arrangements

While the Study Group emphasizes the necessity to reach agreement on the establishment of a Substitution Account, it also recognizes that the trends toward reserve diversification noted above are likely to continue over the next few years. The Group has accordingly considered possible ways in which the official international community might handle such pressures so as to minimize any disturbance or disruption they might cause while an SDR Substitution Account was being established and developed.

One point that may be made at the outset is that the present confusion in the provision of a reserve base for the system arguably itself contributes unnecessarily to the uncertainty felt by private and official holders and thus to the potential for erratic capital flows. To the extent that the developments that are taking place already—such as the gradual emergence of the Deutschemark and, on a smaller scale, the Swiss franc and the yen as reserve currencies—could be made more explicit and transparent, it could be argued that at least this source of uncertainty may be alleviated.

Further, because of the unwillingness of potential reserve centers to allow other central banks to hold significant amounts of their currency in domestic form, such holdings as have developed have predominantly been in external form—most notably in Euro Deutschemarks. (It is estimated that, subtracting the proceeds of the Carter notes issued in December, 1978 from total DM reserves, the proportion of remaining DM reserves held in the Euromarket at end-1978 was approximately 66 percent.) It could be argued that this situation has involved many of the disadvantages of running a reserve currency without using some of the possibilities for controlling its development. In these circumstances, other central banks will tend not to feel any great responsibility for the overall and long-run effects of the developments of which their individual decisions are a part—especially if their individual holdings are fairly small.

Recently, the central banks concerned have all begun to accept to some extent the different roles thrust upon them. This is important because it would facilitate more explicit discussion of the needs, or at least preferences, of the world's central banks. Such discussion might help to engender a much greater sharing of the responsibility for the stability of the system and hence slower and more predictable shifts in portfolio preference. Evidence of broad agreement on portfolio patterns among central banks should also help to reduce the volatility of private markets.

Such discussion and negotiation would be bound to be difficult and protracted. Compromises would be required between the preferences of potential or actual reserve centres among each other and with non-reserve centres as to the volume of reserve assets and the conditions under which they would be supplied in each currency. The Group recognizes, moreover, that quite apart from the formidable technical and negotiating problems that would be involved, significant developments in this direction could have implications for the wider and more fundamental questions of exchange rate and intervention policies and the global volume of reserves. Nevertheless, the Group believes that, for two main reasons, the possibility of more explicit arrangements for reserve currency holdings should be further explored. First, as has already been stressed, potentially disruptive pressures for diversification could still erupt at any time; and secondly, there would be genuine potential benefits for all parties if some forms of agreement, however rough and ready, could be reached on the way in which reserve-holding patterns might develop.

For example, potential reserve diversifiers might give formal or informal undertakings only to diversify their reserves in line with prearranged guidelines—such as an agreement on their part to acquire no further holdings in Eurocurrencies—in return for a degree of access to the money and capital markets of the new reserve centres. Such arrangements would offer developing countries, in particular, a limited freedom which they do not possess in many cases at present, whilst also offering to the reserve currency centers a somewhat greater degree of control over capital movements into and out of their currencies. Further, current exchange rate instability is at least partly caused by the inadequacy of the volume of borrowing in the capital markets of potential reserve currency centres in relation to potential capital inflows.

Whether such a framework for the discussion of reserve holdings contributed to exchange rate stability might depend to some extent on the methods used for achieving any further degree of diversification. Two broad approaches may be distinguished in principle:

(i) the balance of payments channel.

(ii) the foreign currency substitution channel.

The balance of payments channel. New reserve currencies might develop as the result of policies followed by the potential reserve centers whereby their customary surpluses on current account were substantially more than offset by deliberately stimulated long-term capital outflows. One implication of such developments that might be unwelcome is that, if the U.S. balance of payments remained unchanged, the total of world reserves would be thereby increased. There may in any case be a preference among the potential reserve centers to maintain in the future smaller current account surpluses, with occasional moves into deficit, rather than foster large net capital outflows: and there may also be practical difficulties in the relative lack of development of their domestic capital markets. On the other hand, should it prove very difficult permanently to reduce the current-account surpluses that these countries have generally experienced, it can be argued that fostering large net capital outflows would be a helpful contribution to the international adjustment process and to exchange rate stability.

An alternative or complementary approach to the balance of payments channel is the **foreign currency substitution channel.** Problems posed by the relative lack of development of surplus countries' capital markets might also, to some extent, be avoided by this approach which allows for diversification outside the markets. For example, the strong currency countries could issue obligations in their own currencies in exchange for dollar claims on the United States. The advantages would be that they could thereby arguably sterilize the domestic monetary effects of foreign currency inflows before they actually occurred; that such techniques would be independent of the state of the countries' domestic financial markets; and that if the claims were in the form of long-term placements with central banks they could be less volatile than short-term capital inflows. This approach might be considered analogous to a swap, with one leg of it in longer-term assets. However, strong currency countries would under this proposal have to accept further accumulations of dollar reserves and presumably the resultant exchange risk, unless bilateral arrangements are agreed between participating countries to share the exchange risk or the strong currency countries deposited newly-acquired dollar reserves in the Substitution Account.

Techniques of financial diplomacy which might influence the currency preferences of official holders at the margin are inappropriate when dealing with a very large and diverse group of private holders. Private holders will continue to respond to the actual and perceived underlying economic conditions. However, the experience of recent years suggests that private holders are often influenced by fears or beliefs that official holders are diversifying. To the extent that the fears could be calmed by the knowledge of the existence of inter-central bank agreements there might be an improved degree of stability in the currency distribution of private holdings.

Conclusion: The Study Group considers that there is an urgent need to reach agreement on a Substitution Account meeting the needs of all participants, attracting widespread support and with strong links to the private sector. The scheme would not solve all the problems of the international monetary system: it is not designed to do so. But it would mark an important step forward in the evolution of the system. Failure to reach such an agreement would risk adding to the volatility of exchange rates and the instability of current international monetary arrangements. At the same time, granted the likely strength of the trend towards the diversification of currency reserves, and the time it will take to put a Substitution Account into place, it is desirable that more explicit discussion should develop among the central banks concerned as to the ways in which the legitimate preferences of all parties may be met.

H. Johannes Witteveen
Peter B. Kenen
Christopher McMahon
I. G. Patel
Wolfgang Rieke
Robert V. Roosa
Robert Solomon
Gengo Suzuki

OBSERVER
Jacques J. Polak

Officers of the Group

H. Johannes Witteveen	Chairman
Robert Pringle	Executive Director
Geoffrey Bell	Executive Secretary
Robert Solomon	Treasurer

One World Trade Center
Suite 1630
New York, New York 10048
Tel (212) 775-9100

Group of Thirty

The Group of Thirty was established in December 1978, in order to explore the basic problems in the functioning of the international economic system. It meets twice a year, for two to three days at a time. Between these meetings, study groups and researchers gather material to serve as the basis for the Group's discussions.

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Group of Thirty

The Foreign Exchange Markets under Floating Rates

A study in international finance

By
The Exchange Markets Participants'
Study Group

Study Group Members
Hubert Baschnagel, *Swiss Bank Corporation*
Geoffrey Bell, *Schroder International Ltd.*
Herbert Evers, *Marine Midland Bank*
Richard K. Goeltz, *Joseph E. Seagram & Sons, Inc.*
Scott E. Pardee, *Federal Reserve Bank of New York*
Dennis Weatherstone, *Morgan Guaranty Trust Company, Chairman*
Vaughn R. Blake, *Brown Brothers Harriman & Co., Secretary*
Robert Pringle, *Group of Thirty, Executive Director*

Published by

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The Foreign Exchange Markets Under Floating Rates

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The Foreign Exchange Markets Under Floating Rates

Introduction

The following report grew out of an initial study presented to the Group of Thirty at its first plenary session in Bermuda early in 1979. That study emphasized the growth and significance of foreign exchange-related activity in the United States, and centred on the New York market. Subsequently, the Study Group of exchange market participants, which undertook the initial study, organized similar surveys of other major financial centres. This report summarizes the results. It is based on written answers to a questionnaire and selected interviews conducted with banks and international industrial corporations located in Europe and Asia as well as the United States.

The bank questionnaire was sent to 56 commercial and merchant banks, varying considerably in size and in the extent of their international operations. Twenty of the banks are located in London, 16 in Germany, Switzerland and France, 10 in Tokyo and Singapore and 10 in the United States. The banks in the United States were approached as it became clear that the survey was eliciting a good response, but the New York market remains underrepresented in the report. The industrial corporations that participated in the survey generally represent large, capital intensive businesses, experienced in international operations. It is important to bear this in mind when considering the main findings of the survey. The survey was completed in October, 1979.

These findings are grouped together in two major sections:

Part I: *Summaries of the evidence*
Part II: *Reports on answers to the questionnaires*

The broad purpose of the questionnaire was to ascertain the *views of market participants* in the principal market centers on the functioning of the foreign exchange markets since the advent of floating exchange rates. The report does not analyze the growing influence and impact of small, but emerging, foreign exchange market centres in developing countries.

It should also be understood that the structure and content of the questionnaires themselves, though carefully drafted, may have given rise to some responses that, out of context, are misleading. Certainly some of the statements made may be disputed. In the report on answers to the banking questionnaire, in particular, it is important to bear in mind that the answers should not be interpreted as referring to any particular episode or period, except where the question specifically makes reference to such a period or episode. The emphasis of this phase of the study was on collecting the raw data of market impressions on the functioning of the markets.

I and the other members of the Study Group wish to thank all those who assisted in the preparation of the survey. We owe a special debt of gratitude to the members of an advisory committee of market participants which was formed in London. The members of that committee are: Mr. John Sangster (Bank of England); Mr. R. Barham (Morgan Guaranty Trust); Mr. W.J.F. Batt (National Westminster Bank); Mr. A.J. Price (Deutsche Bank); and Mr. Peter Robeson (Baring Brothers). The assistance given by this committee was invaluable both in the drafting of the questionnaires and in other phases of the study.

Dennis Weatherstone

PART ONE

Summaries of the Evidence

How Bankers View the Markets

In general, the picture that emerges from this survey is of a foreign exchange market that has adapted well to the exigencies of a 'managed' floating rate regime. On balance, the market has become more competitive as a result of the entry of new banks, the growth of new centres (notably in the Far East), the development of international brokerage and the wider and more rapid dissemination of news. In historical perspective, perhaps the most important development of these years has been the resulting growth of a global, 24-hour foreign exchange market.

Non-bank customers have benefited from these developments in several ways. Margins have been reduced; the habit of 'shopping around' for the finest quotations has grown; and the options open to corporate treasurers have widened in terms both of the timing of transactions and the institutions through which they may be executed. In most centres, a majority of banks reported that profits from foreign exchange trading had not kept pace with the growth in volume. In reply to the question as to whether earnings have increased at the expense of customers or central banks, most of those who replied asserted that the bulk of the growth in profits had accrued at the expense of central banks.

Defects

On the other hand, the market is also thought to have developed some defects, as compared to the situation before the advent of floating (though many respondents attributed these to exchange rate instability rather than to floating itself):

(a) There is clear evidence of an increasing concentration on the spot market, and the availability of longer term (over one year) forward contracts has become more limited. Some of the smaller banks that specialized in this business (notably in London) have been squeezed out of the market by the increase in risk and the lessened acceptability of their names after the Herstatt collapse.

(b) There is some evidence of a reduction in the 'depth' of the market (defined here as its ability to absorb large trades without temporary distortion), though this varies considerably from one centre and currency to another. Bankers report a greater number of smaller spot trades by contrast with the larger trades possible in the pre-Herstatt floating period.

(c) The rapid growth of instantaneous, world-wide communication of news, and in the number of factors thought to influence exchange rates (such as various definitions of countries' money supplies, etc.) has put a premium on the ability of the markets to discriminate between relevant and irrelevant information. This occurred at a time when the growth in the number of market participants brought an increase in the number of younger and less experienced dealers, and when international brokers were introducing many new 'names' to the market. Such institutional factors may have made a marginal and temporary contribution to exchange rate volatility.

(d) More serious is the allegation that some banks use the newer means of communication, such as commercial monitor screens (and 'open voice' trading) to manipulate the market by putting in false inputs.

(e) Some respondents alleged that some very large banks (both in the United States and Continental Europe) and the trading companies in Japan are able to 'lead' the market. This factor (if true) may also have contributed to increased volatility. Indeed, although the markets are generally believed to have become more competitive, some bankers claimed on the contrary that they had become oligopolistic due to the increasing market power of a very few large banks. Such allegations may, however, result from a confusion between large trades (which naturally tend to be transacted by large banks) and the use or misuse by banks of their own resources. It is worth noting that in no centre did a majority of respondents believe that the markets had lost "efficiency" because of the reduced role of smaller banks.

(f) Among the factors deemed to have caused a loss of market 'efficiency' in practice (see table 4), *the intensification of supervision or regulation of banking* was mentioned by a majority of respondents in Zurich; *the maintenance or intensification of ex-*

change controls by a majority of respondents in Frankfurt and New York; the larger scale of *official intervention* by a majority in Frankfurt; the tightening of *guidelines issued by banks' own management* by those in Zurich; changes in *accounting standards* by respondents in New York; and awareness of the *increased magnitude of foreign exchange movements* by a majority in London and Frankfurt. On balance, however, most bankers did not believe that the markets had lost "efficiency."

"Overshooting"

Nearly all bankers, in all centres, said that the markets "overshoot" in the short run, but a large majority thought that they were reasonably accurate in determining medium-term trends and few of them thought that short-term over-and undershooting contributed to economic disequilibria. On the contrary, several said that overshooting forced governments to adjust their domestic policies and thus contributed in this way to more stable conditions. Until governments adjusted, however, markets tended to be 'one way.' The speculator, narrowly defined, had become too small to perform his classical role of helping to shift the market towards equilibrium levels; nor have corporations taken on this role because their policies on leading and lagging of trade payments often reinforce rather than counter market distortions.

Central banks are not thought to have filled this vacuum by their intervention policies. One of the striking features of the survey was the criticism of central bank intervention made by many respondents. Bankers in the Far East, and notably in Singapore, were in favour of a minimal degree of intervention, or none at all; respondents in the United States appeared to view larger-scale intervention as indispensable to the orderly functioning of the markets; bankers in the three continental European centres were particularly critical of the techniques and *modus operandi* of intervention, while not generally disputing the need. Several acknowledged that coordination between monetary authorities in Europe (particularly between Zurich and Frankfurt) had improved, whereas coordination with the Federal Reserve Bank of New York remained more difficult.

The markets as viewed by corporate treasurers

Based upon a limited sample of approximately twenty of the largest, most sophisticated, capital intensive multinational corporations, it appears that businesses have adjusted to the floating rate system rather well. Most report that their basic financial philosophy has not changed. Significantly, corporate managements believe that floating rates have not materially impeded international trade or investment. However, foreign exchange exposure management has required more attention from senior management, the costs of conducting international business may have increased slightly, and judgments on the future course of the exchange rates of major currencies play a larger role in corporate decision-making than used to be the case.

The general view appears to be that the dimension of risk has changed, especially in the shorter term, but not to a degree that affects materially a corporation's willingness to make direct foreign investments or to engage in international trade. The short-term requires closer monitoring than under a fixed-rate system. This has led in many cases to greater centralization of policy making and a more rigorous examination of the implications of foreign exchange movements for financial decisions. Also, for American corporations, there is more concern about the effects of foreign exchange fluctuations on reported interim financial statements as a result of present accounting conventions. Daily fluctuations are believed to increase risk in certain ways, influence the timing of transactions, and in some cases shorten the time horizon. Notwithstanding the possibility of having to record a foreign exchange loss, with few exceptions corporations state they have not foregone an economic gain to an accounting charge. They do, however, allow that the effects of major foreign exchange fluctuations are considered.

Although floating rates have resulted in changes regarding the short-term, they are perceived as having a negligible influence on decisions for the long-term. The awareness of foreign exchange considerations has been heightened (and in some cases foreign exchange considerations have become the dominant factor in portfolio investment and borrowing decisions), but short-term fluctuations remain subordinate in basic business decisions, especially for commitments to new property, plant and equipment. This indifference is attributed to two factors: (1) the costs associated with floating rates are small relative to other factors influencing their investments, and (2) over time, foreign exchange rates should mirror real economic developments. "Floating rates have made foreign investment more complicated but not less attractive." Most said floating rates introduced an additional element of risk into international trade and investment but that it was not material. No respondents said that floating exchange rates had resulted in the elimination, deferral or reduction of any foreign direct investment but some indicated a higher rate of return was required of commitments abroad; none said that they influenced the level of their company's international trade.

However, a minority of respondents said that floating exchange rates have raised the cost of conducting business internationally. More frequent, but still selective, hedging of foreign exchange exposure entails costs, even though it was thought to be impossible to measure these. There were also costs in establishing an exposure management team and in the amount of management time and effort directed to foreign exchange matters. But again, some respondents added that these may be related more to exchange rate volatility than to floating rates. Moreover, a number cited the better and more comprehensive information required and received by corporate headquarters.

With regard to pricing and invoicing policy, only a few respondents said that they raised prices to cover the incremental expenses of managing foreign exchange positions and hedging. (It is notable, by contrast, that some bank respondents believed that companies do include the higher cost of more extensive foreign exchange cover in their prices, "whenever they are able.") With regard to invoicing policy, a preference for invoicing in strong currencies if possible was expressed, because of the short-run benefit, even though it was broadly agreed that *in the long run* market forces will preclude any supplier or customer from using this aspect of a contract to extract a consistent gain. (Also, it may be easier to pass on price changes resulting from exchange rate changes rather than those resulting from policy decisions.)

Many respondents had anticipated a diminution of capital controls and trade barriers with the advent of floating exchange rates. Although some relaxation had occurred, it has been much less than anticipated. Furthermore, in some instances, e.g. the United Kingdom, the greater freedom is properly attributed to developments other than those in the foreign exchange market.

There was a remarkable consensus among respondents in their general view of the foreign exchange markets. They agreed that the price of a currency does accurately reflect all information available to market participants (i.e. that it is an "efficient" market) but also that at any given time an exchange rate often did not reflect the "intrinsic" value of a currency. As one put it, much of the "combined information" is "misinformation or guessing" that is frequently exaggerated by latest news, good or bad, for a currency. In this regard they agreed with the respondents to the banks questionnaire. With regard to future movements in rates, none believed that he could consistently predict movements more accurately than "the market," but many thought they could do so "often enough to justify making the attempt." Purchasing power parity comparisons, i.e. adjusting currency values for differential inflation rates, was the most widely accepted method employed in forecasting appreciations or depreciation of individual currencies. Some stressed that they reckoned they could thereby predict *trends* more accurately than "the market," which at any given time was ruled above all by psychological factors.

In sum, the evidence of this survey suggests that major corporations have accepted the floating rate regime as one that has led neither to large-scale disruption of their international activity nor to disillusionment over future investment opportunities, though there is some evidence that it may have raised their costs marginally. The major difficulty in interpreting such results, as the respondents themselves emphasized, is that of distinguishing between the effects of floating rates and those of increasing exchange-rate volatility. Although not explicit in the responses, one can readily infer a preference by industrial corporations for floating rates, if the currencies adjust gradually to changes in real economic factors. This proviso is a key point; the volatile fluctuations experienced over the past few years are deemed disruptive.

PART TWO

Survey of Market Opinion

1. The Survey of Banks

This section contains reports on the responses of banks' senior foreign exchange managers to the questionnaire reproduced in full on the following pages. It was mailed to 56 banks in London, New York (and other cities in the USA), Frankfurt, Zurich, Paris, Tokyo and Singapore. Written replies were received from 35 banks in time for inclusion in the report, and supplementary interviews were conducted with 30 banks. Central banks were not asked to answer the questionnaire (which was designed for commercial banks), but, as is evident from the reports, generous help was received from several central banks. Some banks supplied written answers but were not available for interviews while others gave interviews but did not supply written answers.

Questionnaire for Banks

Introduction

The following questions are an attempt to assess how floating rates have been working and the impact of development in the markets themselves. They are *not* an opinion poll on preference for fixed or floating rates.

In answering any quantitative question or in trying to quantify an answer it is essential (although admittedly very difficult) to bear the effects of inflation in mind and to attempt to answer in real terms.

Structure of the Market

1. Has the number of participants in the market, both banks and corporations, increased markedly since 1973?
2. Over this period has there been a marked increase or decrease in real terms in the volume of
   (a) interbank business;
   (b) customer business?
3. If your answer to either part of Question 2 is positive, what would you say are the main reasons for the increase (or decrease)?
4. Has the proportion between interbank and customer business changed, and if so in which way?
5. Have spreads generally widened, narrowed or remained the same?
6. Have the rapid advances in communications and the instant reporting of news had any significant effect on markets?
7. Has the internationalization of broking activity had a significant effect on the markets?
8. Do futures markets in exchange, like the IMM in Chicago, now have a significant influence on world markets, and if so in what way?

Behavior of the Market

9. Allowing for the fact that in recent years leading economies have diverged more markedly, do you consider that exchange markets have been reasonably accurate in determining short or medium term trends for the exchange rates of leading currencies?
10. Alternatively, do you think that markets overreact to changing circumstances and move exchange rates far beyond underlying equilibrium levels, i.e. to overshoot, and contribute in the process to the divergence among economies?
11. What has been the role of speculation in the markets? Is there any evidence that the speculator has played his "textbook" role of damping down movements in exchange rates? Or has speculation on balance added to such movements?
12. Have markets on balance gained or lost in terms of their breadth, depth and resilience?
13. If in your opinion the markets have lost efficiency in recent years, what would you say are the main reasons for this? Is it
    (a) Due to the intensification of supervision or regulation of banking by central banks and other supervisory bodies?
    (b) Due to the maintenance or intensification of exchange controls limiting the freedom of the market?
    (c) Due to the larger scale of official intervention in the markets?
    (d) Due to the tightening of guidelines issued by the banks' own management?
    (e) That companies themselves have been forced to become overly protective in foreign exchange by recent changes in accounting standards and to make shorter-term judgments than before?
    (f) That, while the number of participants has increased, the aftermath of Herstatt has substantially reduced the role of smaller banks and organizations and forced them to be little more than "in-and-out" traders?
    (g) That awareness of the increased magnitude of foreign exchange movements in a floating rate world has not only alarmed risk-averters but frightened those who would otherwise be risk-takers?

14. Have futures markets in exchange reduced or increased the volatility of exchange markets?
15. Companies claim to act mainly protectively but is their perception of "protection" always consistent? Or do they tend to adopt a policy and then abandon it under the pressure of events?
16. In your opinion have central banks rendered the better service, from the point of view of the functioning of the markets, when intervening or abstaining?
17. Would you wish to see greater participation/commitment by central banks as a whole?
18. Turning to experience since the measures of November 1st, 1978 have you experienced greater or less difficulties since that time in finding counterparties for transactions?
19. Do you recognize any other practical differences between pre- and post-November 1978 market conditions—in terms, for instances, of the day-to-day volatility, width of quotation and general depth of the market?
20. Have you noticed any change in the attitude of your customers towards covering their exchange risks?

Forward Markets

21. Have floating rates produced more forward business from commercial companies? Or do you think that this business would also have increased markedly under a system of fixed rates?
22. Has *covered* interest rate arbitrage been reduced—because of possibly wider spreads?
23. Or is more interest arbitrage now done on an uncovered basis?
24. Is there more or less anticipation of comparative interest rate movements through forward/forward operations?
25. Or has the development of interest rate futures in certain centres diverted some of this type of business from forward markets?
26. Have floating rates impaired the longer date forward markets, say beyond one year?
27. Have the larger banks concentrated more on the spot markets and would you agree that those smaller banks that specialized in longer date forwards until 1973 have tended to be squeezed out of business? If so, what would you say are the main reasons for such developments?

Costs

28. Considering solely foreign exchange trading profits, and leaving aside foreign exchange earnings from loans and investments, have your trading profits increased in real terms (after taking account of inflation)?
29. If so, would you think that this has been the general experience of banks, once the market had overcome the dramatic losses associated with Herstatt and similar disasters?
30. If your answer to 28. is positive, have the increased earnings been at the expense of customers or central banks?
31. In your view have floating exchange rates increased the costs of international trade and investment in real terms?
32. Have they made any contribution to inflation?

Reports on Answers to the Questionnaire

Structure of the Market

1. Has the number of participants in the market, both banks and corporations, increased markedly since 1973?

London. All respondents (with only a single exception) agreed that the number of bank and corporate participants had increased markedly since 1973 and one respondent said that there had been an increase in regular and not just occasional bank participants. However, some added that the number of active market makers had decreased.

Among the reasons given were that more banks had extended their international networks and that more corporations had established foreign exchange trading departments. Some respondents believed that the number of corporate participants had increased more than the number of bank participants.

Although the number of European banks regularly dealing with London stopped growing or even fell off temporarily after the Herstatt collapse of 1974, that was offset by the entry into the market of more Japanese, far eastern, middle eastern and US regional banks as well as European state and cooperative banks. The growth in the number of bank participants was attributed mainly to the entry into the market of the banks listed above plus the re-entry of those European banks which pulled out for a time after Herstatt.

However, one respondent said the increase in the number of new banks in this market seems to have slowed down since about 1976.

Frankfurt. After a temporary post-Herstatt decline, the number of banks regularly in the German foreign exchange market is reported to have increased, although modestly and largely through an increase in the number of branches dealing in foreign exchange in the case of banks already in the market. (Quite distinct from this trend in the German market itself is the reported increase in the number of German banks which have become active in other foreign exchange centres like Luxembourg, Singapore and Hong Kong.)

Some increase in the number of customers has been reported in the German market since 1973 on the growth of trade, hedging and inward and outward international investment. But several German bankers said that this increase in numbers may not have been as large as in some other centres because about 85 percent of Germany's exports and about half of all imports are invoiced in Deutschemark. The proportions are higher than average at some companies, so that the number of companies needing regular foreign exchange service is thought to be less than in some other countries.

Zurich. A majority of respondents reported no increase in the number of bank participants since 1973 and some went further in saying that a decline in the number of regular bank participants had been offset only partly by a rise in the number of occasional bank participants. However, a majority reported some increase in the number of customers.

Paris. The number of bank and non-bank participants is reported to have risen since 1973.

Tokyo. All banks said that the number of participants had increased, one adding 'tremendously'. The number of banks eligible to participate rose from 129 to 181 from end-1973 to end July, 1979, with the number of brokers rising from 6 to 10. The number of 'market leaders' is put at between 20 and 30.

Singapore. The number of participants has increased, though one respondent qualified this by saying that the number of 'active trading banks' had fallen whilst the number of corporate participants had grown.

New York. All respondents gave a positive answer.

2. Over this period has there been a marked increase or decrease in real terms in the volume of
   (a) interbank business;
   (b) customer business?

The official estimates tabulated in Table I are no more than approximations and it was emphasized in all centres that volume does not expand (or contract) steadily from year to year, but that it rises at times of exchange rate unrest and falls during periods of relative stability.

Volume in *Frankfurt* was especially high in 1973 during the final breakdown of the Smithsonian arrangements and extremely heavy diversification into Deutschemark at that time. It remains higher than in

London partly on continuing international reserve and asset diversification into DM, the greater use of DM than sterling as an international trading and not merely investment currency and the interventions required for the European Monetary System.

Table 1

Daily Average Foreign Exchange Turnover
Spot and Forward
$ billions equivalent

	1973	1979
Frankfurt	19—20	15
London	4—5	10—12
Zurich	5—6	5
Paris	1	3—4

Source: central bank estimates in each centre.

The smaller decline in average daily turnover in *Zurich* between 1973 and 1979 is similarly ascribed partly to the lesser asset diversification into Swiss franc during the latter year, compared with the former, which is due partly, in its turn, to the tighter restraints imposed in 1978 on non-residential investment in Swiss francs.

The considerable rise in *London's* officially estimated daily turnover is ascribed in large part to the growth of the Eurocurrencies market (even though the proportion of that market centred on London was reduced during the 1970s).

The very large increase in the estimated daily average turnover in *Paris* is ascribed partly to an increase in that market's bank and nonbank participants and also to increased intervention within the European Monetary System.

The impressionistic evidence given by bankers in written answers and interviews for this survey do not tally in all cases with the official estimates tabulated above. This may reflect the projection of some banks of their own experience onto their markets as a whole. A summary of their evidence is the following:

London. All respondents reported a marked increase in real terms in the total of foreign exchange turnover since 1973 and a proportionately greater increase in customer than inter-bank business.

However, if one deflates the officially estimated increase in the London market's daily turnover from 1973 to 1979 by, say, a rise of more than 200 percent in world trade prices during that period, then there has at most been a marginal increase in London's real foreign exchange business in the past six years (indeed, on that yardstick there has been a marked increase only in Paris and a considerable real decline in Frankfurt and Zurich). It follows that the experience of some respondents may not have been representative of the market as a whole, i.e. these banks may have increased their share of the market.

A similar reservation applies to the reports of many banks that their customer business had risen more than their inter-bank business, since the proportion of customer and inter-bank business in the market as a whole is not thought to have changed significantly since 1973 on the

Table 2

Inter-Bank Turnover as a Proportion of Total Spot and Forward Turnover, 1979

London	90 percent
Frankfurt	75—90 percent
Zurich	90 percent*
Paris	85—90 percent

Source: central bank estimates.

*In Zurich the proportion is estimated at 80 to 85 percent excluding inter-bank deposit business between Swiss banks, which is conducted through the dollar in the absence of a domestic money market.

Table 3

Proportion of Foreign Exchange Transactions via the Dollar in the First Instance, 1979

London	99 percent
Frankfurt	90 percent
Zurich	95—99 percent
Paris	60*

Source: central bank estimates.

*In Paris, about 15 percent of turnover is in DM, about 10 percent each in Sw.fr. and sterling and the residual 5 percent in other currencies. The proportion going through the $ has declined from about 80 percent in 1970.

official estimates of market structure. As in all foreign exchange centres, a relatively small base of customer business creates a very large volume of offsetting interbank business to match requirements for odd sums and odd forward maturities. The proportion of customer business is bigger at some banks and classes of banks than others, as in the case of a clearing bank which said the proportion of its customer business to total foreign exchange business had risen from 20 to 25 percent between 1973 and 1979.

The increase in total volume reported for London is reported by some banks to have been accompanied also by an increase in the number of transactions; whereas spot transactions of $5 to $10 millions were common before 1973, there was now a greater number in the range of $2 to $3 millions, partly reflecting a greater reluctance of banks to leave positions open overnight.

Frankfurt. Total market volume collapsed after Herstatt and made a partial recovery only from 1978 on the dollar crisis of that year. The decline in business over the six years to 1979, taken as a whole, is reported to have been particularly steep at smaller banks who are no longer able to take positions on the pre-1973 scale, and their business is said to have shrunk in the forward market even more than in the spot.

Non-bank volume is reported to have increased in line with Germany's trade and investment, on more extensive hedging, on the growth of foreign investment by German companies and asset diversification into Deutschemark by non-residents. Nevertheless, on the official estimates there has not been any marked change in the past six years either in the proportion of customer to interbank business nor any significant change in the proportion of total volume going in the first instance through the dollar (the proportion of about 10 percent which does not is represented partly by intervention within the EMS and partly by direct business on the part of some Hamburg banks with Scandinavian currencies and a similarly direct business by some banks in Dusseldorf and Cologne with Benelux currencies).

Zurich. Nearly all banks supported the official estimates of a decline in the money volume of foreign exchange transactions since 1973 and a steep decline in real terms. Nevertheless, a majority of banks report an increase in the proportion of customer business. At 15 to 20 percent of total turnover (excluding inter-bank deposit business transacted through the dollar) this is indeed higher than in other centres.

Paris. A substantial increase was reported here both in inter-bank and customer business.

Tokyo. All respondents said there had been a marked increase in both spot and forward business in real terms. One detailed reply estimated that 'domestic foreign exchange market transactions' had grown 5.3 times in real terms since 1972, after adjustments for changes in export and import prices and in the exchange rate; in particular, the volume of 'swap' transactions rose 11 times in real terms, against a doubling during the previous seven years, under fixed rates. There had been a much more rapid increase in interbank business than customer business, with 'pure market transactions' growing 'conspicuously'.

Singapore. All respondents said that both types had increased, with a much more rapid growth of interbank business. One reported that interbank business had increased by 60 percent p.a. and customer business by 8 percent p.a.

New York. Replies indicated that both types of business had increased, with interbank business possibly again growing more rapidly.

3. If your answer to either part of Question 2 is positive, what would you say are the main reasons for the increase (or decrease)?

Reasons given for the increase in the real volume of foreign exchange business since 1973 include the following:

- The increase in world trade.
- A tendency by some banks to trade more actively in the interbank market to compensate through increased volume for narrowing spreads on business with non-bank customers.
- Increased hedging by companies of currency flows and increased matching of currency assets and liabilities (the latter partly connected with increased borrowing in international and not just domestic financial markets).
- Growth in the number of bank and non-bank market participants.
- Increased hedging and to a lesser extent speculation during times of pressure on a particular currency (i.e., sterling 1976, dollar 1978/79).
- Associated with the above, greater switching of OPEC assets during such periods and asset switching also by central banks outside the Group of Ten industrialized countries.

- Increased intervention by G-10 central banks at times of market instability.
- A growing tendency in some international companies to trade foreign exchange actively for profit (rather than for the more conventional purposes of covering and matching).
- Growth of spot and forward business resulting from increase in international foreign currency lending.

In *London*, unlike some other centres, restrictions on foreign exchange trading were not cited as a market impediment, although exchange control imposed limits on banks' positions after the foreign exchange markets generally reopened in 1951.

Frankfurt. Banks report that temporary increases in volume in disturbed markets result mainly from increased hedging of current transactions and protection of assets by non-bank customers. Inter-bank business then increases partly on the base of enlarged customer business, but partly also by banks seeking the greater profit opportunities offered by wide exchange rate movements.

In Germany, the growth of foreign exchange business has been impeded partly by official constraints and partly by stricter management control within banks since Herstatt. The main official constraint on German banks is that their open positions may not exceed 30 percent of risk capital (equity plus reserves) and brokers may not run positions. Non-banks are not, however, similarly restrained.

Zurich. A majority of banks attributed the decline in inter-bank business since 1973-74 to official restraints reinforced by stricter management control within banks. The effect has been offset only in part by the absence of a money market in Switzerland, which has had the effect of channelling inter-bank deposit business between the country's banks through the dollar.

Tokyo. The increase was attributed above all to the marked increase in Japan's trade and capital transactions, together with the gradual liberalization of exchange control and increased hedging of foreign exchange risks by Japanese companies. A change from the use of outright forwards to a combination of spot and swap transactions for obtaining exchange cover also boosted volume.

Singapore. The reasons most frequently cited, apart from the increase in the number of participants, were the geographical location of Singapore, which made it suitable to act as a link in the emerging "24-hour" global market, and the greater experience of market participants. One comment was that banks now tried to be on top of every situation, to act and react to market news, and that this made for a large turnover.

New York. The growth was attributed to changes in accounting practices (FASB 8), the growth in the number of foreign banks in New York, recycling of OPEC surpluses, and increased hedging by companies.

4. Has the proportion between interbank and customer business changed, and if so in which way?

Answered in (1) and (2) above.

5. Have spreads generally widened, narrowed or remained the same?

All Centres. In the course of interviews, a supplementary question was asked about spreads to non-bank customers.

The number of respondents who said *interbank spreads* had widened was exactly twice the number who said they had narrowed or remained unchanged. However, pressed for amplification, nearly all said that such spreads widened in volatile markets, but narrowed in calmer periods.

Some banks said that *interbank spreads* used to be about 1 point up to 1971; that they widened to around 2 to 3 points in the early 1970s; that they were now commonly 5 points in stable markets, but often 10 points and occasionally as much as 25 points in volatile markets.

A major contribution to the widening of spreads in unsettled markets was said to be made by the temporary withdrawal or partial withdrawal of some banks, especially smaller ones. There was increased reluctance to make a market at such times.

Nevertheless, some banks suggested spreads had widened less than they might otherwise have done because of the greater number of participants and increased competition in the interbank market.

Some banks pointed out that the widening of spreads looks less dramatic when related to the greater movement in spot rates. For instance, the widening of interbank spreads to a range of 5 to 10 points from about 1 point at the start of the 1970s looks modest compared with the increase from about 10 to as much as 200-400 points in daily fluctuations between the beginning of this decade and more recently.

A point made was that the absolute widening of spreads has contributed to a more efficient market, finer shading of quotations being possible within spreads of 10 points on fluctuations of 100 points than had been possible on spreads of 1 point on fluctuations of 10 points. This, in turn, was said to have contributed towards a differentiation of spreads quoted to banks in the market, mainly on the basis of their size, comparable to the differentiation between bid and offered rates quoted to banks of different status in the Eurocurrencies deposit market.

On the related point of *spreads to non-bank* customers, all banks interviewed agreed that these had narrowed considerably in recent years, especially to big customers. One bank described the narrowing as "drastic"; another said, "It is hardly possible for customer margins to shrink any further." The reasons given included:

- increased interbank competition;
- greater customer sophistication, partly resulting from access to more information allowing comparison between bank quotations and active "shopping around" instead of relying, as before, mainly on the customer's own bank's quotations;
- increased awareness by large customers of their bargaining power.

Several banks said international oil companies and other multinationals could get interbank spreads "or even better." The banks added that they were nevertheless ready to deal with the multinationals on those terms for the sake of keeping their business as a whole, even though their foreign exchange business with the multinationals generated minimal profits in itself.

One major international bank made the additional point that it received a "pay-off" from the information acquired through the foreign exchange instructions given it by international oil companies; it believes that the oil companies have special or even privileged access to information, especially when the companies are owned or partly owned by governments, and that this information is reflected in their foreign exchange behaviour.

On the other hand, some banks said they could still make a direct return on foreign exchange business with oil and other multinational companies within interbank spreads, in the same way as they could make a return on normal interbank business. Indeed, one bank welcomed the aggressiveness of multinationals for "sharpening the skill of banks."

One bank alone said it declined to deal with non-bank customers, even international oil companies, at interbank spreads but this was a merchant bank whose opportunities for oil company business as a whole may be limited.

An unusual insight into the narrow profit margins on foreign exchange business was given in the 1978 report of Bank Julius Bar and Co Ltd, Zurich. The gross return on foreign exchange operations that year was Sw.fr. 8 million and the net return Sw.fr. 5 million on a turnover of Sw.fr. 30 billions, representing, in the bank's words, an "infinitesimal" profit of 1/6th per mille (0.0167 percent). About half the costs of the bank's foreign exchange operations of about Sw.fr. 3 millions were accounted for by telephone, telex and information system costs and the remainder by staff and general overheads. Yet despite narrow margins, foreign exchange trading provided the biggest single source of 1978 profit growth for this bank in a year when the earnings of Swiss banks abroad were held down, after translation into Swiss francs, because of the appreciation of Switzerland's currency against nearly all others, especially the dollar.

6. Have the rapid advances in communications and the instant reporting of news had any significant effect on markets?

All Centres. A distinction was attempted in interviews between *news* (official statements, statistics and the like) and *market quotations* (as through commercial monitor screens).

About three-quarters of the banks questioned thought the wider and quicker dissemination of *news* and *forex quotations* had made a market impact.

The perceived impact in the case of *news* included:

- creation of wider market interest among customers;
- a contribution to the narrowing of non-bank customer margins;
- a greater tendency to put undue weight on individual news items because of the indiscriminate flow of news, described by one respondent as a tendency not merely to react, but to overreact;
- a growing (and often inaccurate) anticipation of news which, spreading as rumour, makes an impact of its own, even if that impact is often short-lived.

Comments on the quicker and wider dissemination of *forex quotations* (essentially by commercial monitor screens) included:

(a) on the *positive* side:
  - contributes to a worldwide market (stressed in particular by bankers from Tokyo and Singapore);
  - gives smaller banks a better feel of the market;

- gives non-bank customers a better feel too, thus contributing to a finer market (i.e., narrower spreads to non-bank customers);
- has increased information about and awareness of currencies like the Hong Kong dollar and Saudi Riyal and helped promote business in such currencies.

(b) on the *negative* side:

- some banks allegedly use their input merely as advertisement, which can cause ill-feeling when it drives home, more forcefully than might otherwise be the case, that displayed quotations are for guidance only and not firm offers to deal;
- going a step further, some banks deliberately delay updating their inputs to confuse the market about what they themselves are doing; a major international bank almost admitted as much by saying, "When we are busy, updating our display is not a priority."
- going further still, was the allegation that some banks use the screen for deliberate manipulation. A large continental European bank said flatly it had several times done so in the thinner New York market after the European close, pushing up buying prices when it was actually selling.

(c) on a *neutral* level:

- one comment was that the screen was losing its novelty and hence some of its impact.

7. Has the internationalization of broking activity had a significant effect on the markets?

All Centres. The unanimous answer was "yes." The ways in which it was said an impact had been made included:

- widened the market by bringing in new names, including middle eastern, far eastern, smaller European and US regional banks, some of which were previously regarded by major banks as "customers" rather than interbank counterparts;
- contributed through the above to enlargement of the market through more regular participants and greater volume;
- contributed to the emergence of a "24-hour" global market;
- provided another choice to dealing through 'local' brokers—notably in London and New York;

- many banks complained of the erosion of personal relations between banks, which they attributed to the growth of broking (although it might equally be attributed simply to the growth of the foreign exchange market);
- following from the above, some banks complained of the greater risk introduced into the market through the introduction of lesser and relatively unknown names by brokers;
- some banks complained that brokers tried to "push" young dealers into unwise transactions;
- some banks complained that brokers sometimes cause embarrassment by disclosing to one bank the refusal of another to take part in a transaction with it.

8. Do futures markets in exchange, like the International Monetary Market in Chicago, now have a significant influence on world markets, and if so in what way?

All Centres. Most respondents said that futures markets like the IMM had a destabilizing effect, but many described it as a limited one. Points made included:

- some banks know when the IMM itself is running up against its credit lines from banks and can then anticipate wider fluctuations in IMM quotations;
- a minority view was the IMM has an unsettling influence on some exchange rates rather than all and that its impact is correspondingly less on centres where a larger spread of currencies is dealt (this view was expressed in Paris, where the proportion of total transactions through the dollar is considerably less than in other European centres);
- the impact of the futures markets on spot rates was plainly still much less than of the forward markets;
- the main impact of the futures markets is in the thinner US markets which exist after the European close;
- that impact (above) is therefore sometimes an exaggerated one, but it is often also short-lived;
- the impact is usually one way, reinforcing but not reversing existing trends;
- In some centres, the undue influence attributed to the IMM has become a subject of discussion between the central bank and commercial banks although, as yet, without clear result;

- nevertheless, some bankers believe the influence of futures markets may grow, especially when their workings become better understood in Europe and Asia than is alleged to be the case now;
- contrary to the majority opinion which plays down the present impact of futures market, some bankers point out that the IMM already has had an influence on settlement dates for sterling, Canadian dollars and Deutschemark forward contracts.

Behavior of the Market

9. Allowing for the fact that in recent years leading economies have diverged more markedly, do you consider that exchange markets have been reasonably accurate in determining short or medium-term trends for the exchange rates of leading currencies?

10. Alternatively, do you think that markets overreact to changing circumstances and move exchange rates far beyond underlying equilibrium levels, i.e. to overshoot, and contribute in the process to the divergence among economies?

All European and American Centres. A large majority of respondents thought the markets reasonably accurate in determining medium-term trends, but almost all of them thought the markets overshoot in the short run. The observations made include:

- as in nearly all markets, at times of extreme rate volatility professionals tend to be overwhelmed by amateurs, at least temporarily, at which point the professionals abandon their view and concentrate instead on guessing what the amateurs are going to do;
- the equilibriating influence of speculators and buffer stocks (i.e., central banks) is thought to be limited (see answers to questions 11, 16 and 17);
- nevertheless, several bankers said they thought the market had done better in moving towards equilibrium relationships than was possible in the latter days of the pegged system. One banker said that "natural cynicism" had produced more realistic markets than "political optimism";
- several bankers took the view that market distortions did not last long enough to do harm, and certainly did less harm than official attempts to maintain "wrong" rates;
- None of the respondents claimed that short-term over and under-shooting contributed to economic disequilibrium. On the contrary, the point was made that extreme fluctuations occurred only when governments had failed to adjust and that the market's reaction helped to force necessary adjustment, thus

contributing to more stable conditions. The British government's reaction to the 1976 sterling crisis and the official American reaction to the 1978 dollar crisis were cited as examples.

Tokyo. Most respondents said that in the short term (from one to three months) markets have not been 'accurate' but that, over the longer term (six months to a year), they have been.

Some thought that overshooting might have contributed to divergencies between economies but another view was that in the medium to long term the markets will 'without fail' move the rate to an equilibrium level, unless the rate is artificially manipulated.

Singapore. Respondents thought that the markets had been reasonably 'accurate' in determining medium-term trends; and one even maintained they were 'accurate' in the short term as well.

All respondents took the view that volatile rates have not contributed to divergencies between economies.

11. What has been the role of speculation in the markets? Is there any evidence that the speculator has played his "textbook" role of damping down movements in exchange rates? Or has speculation on balance added to such movements?

All Centres. The consensus among respondents is that the speculator, narrowly defined, does not play his classical equilibriating role by having become too small in relation to the market's size to do so; and that the larger volume of asset switching, leading and lagging adds to exchange market volatility, at least in the short run. It was notable that respondents in New York emphasized the "disruptive" influence of speculation.

The answers to this question are linked to the answers given to questions 9 and 10 and to questions 16 and 17 on central bank intervention.

Observations about *speculation* include:

- to the extent that pure speculation plays a part, it nowadays does so increasingly through futures markets like the IMM;
- officially and self-imposed limits on the open positions of banks since Herstatt have reduced speculation by some banks (though others said that the profits recorded by some other banks could only reflect successful speculative activity);
- pure speculation by banks and non-banks (in the sense of uncovered forward sales unrelated to trade or capital transactions) is limited by foreign exchange controls in many countries, though there are ways to circumvent these;

- such speculation is believed to have fallen off, also, as a result of large losses in the past, which are believed to have done more to scare speculators than large profits have done to encourage them;
- uncertainty about what an 'equilibrium' rate for a currency might be has increased;
- the size and unpredictability of central bank intervention is likewise believed to have diminished private speculation, except when the market is one-way and the direction of intervention predictable;
- the belief that speculation has diminished or at least failed to expand in line with the market's growth explains the belief of most respondents that speculation has become too marginal to perform its classical role in this market.

Along with the diminished role of stabilizing speculation, many bankers believe that *asset switching* has been a further destabilizing influence, especially switching by large holders, as in the OPEC countries. In many cases, dollars sold in the course of asset diversification by authorities and other large holders outside the Group of Ten end directly or through commercial banks with the central banks of the G-10.

A destabilizing influence is attributed by many bankers, also, to *leading and lagging* of trade payments. One banker claimed to have been told by a central bank that such leading and lagging against the dollar had built up to $120 billions by October, 1978. This may be true or otherwise, but it seems significant that a well-placed individual believes it to have been true.

On the other hand, some respondents said that even leading and lagging of trade payments had fallen off in recent years following losses incurred by some companies on uncovered positions.

From *Japan*, too, bankers said that speculation in the Tokyo market itself was limited, owing to the close degree of official control. Referring to the role of speculation in general, one respondent said that it had tended to restore equilibrium in the long run; another that it did so only at times when there were a variety of views on the market about a certain exchange rate; another that the kind of speculation prevalent recently brought about abrupt movements in rates. From *Singapore*, however, one bank said that speculation had added depth to the market and had been responsible for initiating the movement of currencies towards equilibrium levels.

Although the answers to this question suggest that most bankers now think that speculation plays a limited or declining role in contributing towards market equilibrium, the final point made in response to questions 9 and 10, above, seems far more persuasive in suggesting that speculation does in fact contribute to medium-term equilibrium by the very extremes of short-term movements which help to force economic adjustment sooner than it might otherwise have been undertaken by governments wishing to give priority to other policy objectives.

12. Have markets on balance gained or lost in terms of their breadth, depth and resilience?

All Centres. As defined in interviews, the answers to this question were:

breadth	(a wider spectrum of participants, currencies and available transactions spot and forward): a large majority thought the market has *gained breadth* in those terms;
depth	(the market's ability to absorb large transactions without undue price movement): *opinions varied* from centre to centre;
resilience	(the market's ability to recover quickly from a price distortion resulting from an exceptionally large trade): a majority said that the market has *gained resilience* on that definition.

The market's greater resilience is attributed partly to its greater breadth. Several explanations were offered (and qualifications made) by those who said that the markets had lost *depth*—a view taken by London bankers in particular:

- the speculator's allegedly diminished role is said to have made some contribution to the perceived loss of depth;
- although the market no longer has the "exaggerated" depth of the pre-Herstatt days ("when a small bank in Germany could come in for $50 millions"), there has been some recovery since that shock to more "sober" levels of depth;
- officially and self-imposed limits on banks' open positions are likewise said to have contributed to lesser depth;
- the amount of depth in the market is said to vary; larger trades are said to be possible at the start of a day than later, especially if there has been central bank intervention between those times;

- the depth of the market is said to vary also in another way, existing to a greater degree at times of calm, but not in volatile markets "when you most need it";
- a marginal contribution to the market's alleged lack of depth, or sufficient depth, is attributed to the necessarily limited discretion given to foreign exchange dealers whose growth in numbers is said not to have been matched as yet by growth in experience and skills.*

On the other hand bankers in Tokyo and Singapore reported that their markets had gained in all three respects.

13. If in your opinion the markets have lost efficiency in recent years, what would you say are the main reasons for this? Is it:
    (a) Due to the intensification of supervision or regulation of banking by central banks and other supervisory bodies?
    (b) Due to the maintenance or intensification of exchange controls limiting the freedom of the market?
    (c) Due to the larger scale of official intervention in the markets?
    (d) Due to the tightening of guidelines issued by the banks' own management?
    (e) That companies themselves have been forced to become overly protective in foreign exchange by recent changes in accounting standards and to make shorter-term judgments than before?
    (f) That, while the number of participants has increased, the aftermath of Herstatt has substantially reduced the role of smaller banks and organizations and forced them to be little more than "in-and-out" traders?
    (g) That awareness of the increased magnitude of foreign exchange movements in a floating rate world has not only alarmed risk-averters but frightened those who would otherwise be risk-takers?

Nearly all Centres. A majority of respondents in New York, London, Frankfurt, Zurich and the Far East centres do not think that the market has lost efficiency in recent years (the question begged here), although nearly all thought that the markets overshoot in the short term. The answers from Paris, New York and the Far East are not included because the sample of banks providing full replies was too small; those New York banks which were interviewed stressed in particular factors (b) and (e). The following table summarizes responses:

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*An illustration of the growth of the foreign exchange community in London was given by a banker who recalled that a City public house sufficed for the community's Christmas party in the early 1960s, but that it has now become necessary to use the Festival Hall for that function.

Table 4

Exchange Market's Efficiency

	Lost Efficiency Because of:	No Loss of Efficiency Because of:
a.	Z	L, F
b.	F	L, Z
c.	F	L, Z
d.	Z	L, F
e.	—	L, F, Z
f.	—	L, F, Z
g.	L, F	Z

Note. The symbols L (London), F (Frankfurt) and Z (Zurich) are used to indicate a majority answer from those centres under each head.

14. Have futures markets in exchange reduced or increased the volatility of exchange markets?

All Centres. The consensus view is that the futures market have increased exchange rate volatility. Beyond that, the answers to this questions were those reported for Question 8.

15. Companies claim to act mainly protectively but is their perception of "protection" always consistent? Or do they tend to adopt a policy and then abandon it under the pressure of events?

All Centres. Nearly all respondents said that companies act inconsistently, but not all bankers criticized them for doing so. Changing policies according to circumstances was not necessarily inconsistent, said one banker. Another went further, saying that companies with policies of selective hedging were in fact following a consistent approach.

Some bankers said that smaller companies followed consistent hedging policies in more cases than larger companies, who tend to have a flexible approach. Companies adopting a flexible approach are sometimes proved right, but are often wrong, according to some bankers, although they added that such companies are gaining experience and improving their performance.

As against the above, several bankers said there had recently been an increase in the number of companies covering regularly or at least very often, partly because of losses incurred in the past and partly in response to the requirements of FASB 8.

Nevertheless, companies do revert to uncovered leading and lagging when markets seem to be moving firmly one way—for instance, some UK firms importing from the US and Japan were lagging dollar and yen payments during the spring and much of the summer of 1979.

A few international companies were reported as speculating regularly and actively for profit, "in some cases to disguise the inefficiency of their manufacturing base," according to one banker.

Respondents in *Tokyo* thought that companies there had taken an increasingly 'positive and flexible' posture towards the exchange rate, with the aim not so much of protecting as of maximizing their earnings. Some major trading companies and manufacturing companies believe that they lead the market, if only indirectly. The most skillful operators are believed to be the large trading companies.

In *Singapore*, companies were thought to behave inconsistently, in the sense (as one respondent put it) that 'protection' can turn into 'aggression' in certain circumstances; e.g. during times of pressure on the dollar.

In summary, the evidence suggests that there is no approach common to all companies, but that selective hedging is very widespread, especially among large international firms.

16. In your opinion have central banks rendered the better service, from the point of view of the functioning of the markets, when intervening or abstaining?

17. Would you wish to see greater participation/commitment by central banks as a whole?

What emerges most clearly from the answers to these two questions is that a majority of UK, German and Swiss banks who answered expressed themselves dissatisfied with the way in which central banks intervene. Consequently they expressed a wish for increased intervention only if the manner of it were improved. Several bankers in Singapore took the extreme view that central banks should abstain from intervention. Respondents from New York and Tokyo were inclined to take a more favorable view of intervention practices.

Some respondents attributed their dissatisfaction to incompatability of national policies, of which central banks are merely agents.

However, several bankers in the three European centres alleged technical incompetence by central banks accusing them, among other things, of being "inconsistent," "unprofessional" and poor at "reading the market." Some bankers saw central banks as taking over the speculator's classical role; but among those who thought this there were some banks which said that central banks performed that function "inefficiently," adding to the volatility rather than smoothing disorderly markets.

As an example, the foreign exchange director of the London branch of one of the world's biggest banks said that on one occasion in 1978, the Bundesbank had ostentatiously bought $30 million at a morning fixing and then quietly sold $200 millions through the market in the afternoon. A continental European banker independently made the same accusation and a central banker said that the charge "might well be true." As remarked earlier in another context, what is significant here is not so much the accuracy or inaccuracy of the story; the significance is that some well placed market participants believed the story to be true or at least possibly true, and that itself is a comment on market perceptions.

In interviews it was alleged, also, that central banks sometimes intervene at the wrong moments and the wrong amounts to achieve their presumed object of stabilization.

On the other hand, several bankers observed that the volatility they alleged central banks have added to the market have helped their banks' profits (and the answers to Question 30 show that many respondents claim to have profited more from dealings with central banks than with customers).

Nevertheless, the complaint was made that some banks had allegedly "privileged" access to their central banks and made "unfair" profits as a result. Nevertheless, several banks urged increased consultation between central banks and leading market makers to improve the effectiveness of official intervention even though that might lead to more complaints about "privileged" access, as reported above.

One answer made by central bankers to the criticisms reported above is that their entry into the foreign exchange markets does not invariably represent intervention; in many cases central banks were merely acting on the instructions of their domestic and foreign customers in the same way as commercial banks.

Central banks interviewed had an answer also to the suggestion that they could best stabilize markets in the classical speculator's way by buying low and selling high for a consistent profit over time. Part of the answer was that central banks are obliged to consider the influence of their actions on their economies as a whole and that they are obliged also to take into account the impact of foreign exchange movements on the value of their foreign currency reserves. Besides that, a central banker pointed out: "If we acted commercially and consistently made foreign exchange profits using our advance, inside information, say of credit policy, commercial banks would be the first to object."

At another level, it was pointed out that central bank cooperation has become closer, especially since 1972 through the "concertation" that takes place four times a day between the central banks of the European Community's member countries plus Switzerland, Sweden and Norway. The first of these daily "concertations" is at 9:30 am European time and the last at 3:35 pm. The central banks taking part inform their counterparts of net changes in their foreign exchange assets on the previous day and the reasons for those changes. The position of leader of the "concertation" changes daily, and the leader exchanges information at the end of each day with the central banks of the US, Canada and Japan. The "concertation" is conducted over specially secured and continuously open telephone lines.

As against the criticisms made of central banks, it is fair to add that two banks, one in London and another in continental Europe, singled out the Bank of England for special praise. Several banks in Switzerland said they welcomed an improvement of communications with the Swiss National Bank; previously they were often obliged to queue when trying to reach their central bank, while the central bank on its side was said to have dealt only with one of the major Swiss banks at a time. Now, however, there are direct lines between the Swiss National Bank and the large Swiss commercial banks allowing a continuous dialogue which, according to banks in Zurich, gives each side a better "feel" of the other. The Banque de France, meanwhile, has direct lines to 20 banks and the Bourse (though not to brokers).

In addition, several continental European bankers praised the improved coordination between the authorities in Zurich and Frankfurt adding, however, that the coordination with the Federal Reserve Bank of New York was less effective because of the Fed's alleged information gap caused by the "isolation" of the US markets. Some bankers in New York, however, said that the Fed had significantly improved its market expertise and intervention techniques in recent years.

18. Turning to experience since the measures of November 1st, 1978 have you experienced greater or less difficulties since that date in finding counter-parties for transactions?

19. Do you recognize any other practical differences between pre- and post-November 1978 market conditions—in terms, for instance, of the day-to-day volatility, width of quotation and general depth of the market?

20. Have you noticed any change in the attitude of your customers towards covering their exchange risks?

All Centres. A majority of respondents said they could not trace significant market changes narrowly to those November's measures alone, excepting for the "improvement" in central bank strategy reported above. One banker said the November measures had reminded the market of the ability of governments to act on a "startling" scale.

Several bankers remarked on greater caution and more covering by business customers. But they attributed this only partly to the November's package and some reported that even the marginal effects of that package had worn off by September, 1979.

A greater influence on markets was attributed to world events like the Iranian revolution, the ensuing further rise in oil prices, the uncertainties created in the middle east and beyond by the Israeli-Egyptian treaty in March and (on a very much lesser scale) the uncertainties created by the European Monetary System.

Forward Markets

21. Have floating rates produced more forward business from commercial companies? Or do you think that this business would also have increased markedly under a system of fixed rates?

All Centres. Most respondents reported an increase in forward business from commercial companies since floating, and at least one bank reported a "notable" increase. However, a very important qualification is that the increase was attributed by several banks to exchange rate instability, rather than floating in itself. Even under the pegged system, forward covering increased whenever exchange relationships came under threat or pressure; and under floating there is some falling off in the business during periods of exchange rate stability.

22. Has *covered* interest rate arbitrage been reduced—because of possibly wider spreads?

23. Or is more interest arbitrage now done on an uncovered basis?

All Centres. A majority of banks who answered these two questions said that covered interest arbitrage had remained about the same or risen slightly, and the same proportion reported no increase in uncovered interest arbitrage.

Bankers in *Frankfurt* and *Zurich* said forward spreads had not in fact widened. Despite that, some banks in Germany said they had stepped up uncovered interest arbitrage to compensate for narrower spreads on their international medium-term loans, running uncovered dollar positions in the Cayman Islands, where the dollar ranks as domestic currency and where dollar positions are not therefore subject to the limitations on forward positions in foreign currencies applying to banks in Germany.

24. Is there more or less anticipation of comparative interest rate movements through forward/forward operations?

A majority of banks in *Frankfurt* and *Zurich* reported an increase in forward/forward business and in some cases a substantial increase. One bank said that the increase in forward/forward positions resulted from the reduction of opportunities for classical arbitrage. Another said that a large part of forward business from customers was not at standardized maturities and that this obliged banks to take forward/forward positions. It was said also that large movements in spot exchange rates provoked the reaction of large interest rate changes, thus creating greater opportunities for forward/forward specialization (although, presumably, greater risks too).

Just under half the respondents in *London*, however, said floating had reduced anticipation of comparative interest trends through forward/forwards, about an equal number said the opposite and a minority said they had detected no change or that they were unable to answer. One bank said the number of such transactions had not grown although the amounts had. Some banks which reported an increase said that it had been only slight. One of those which reported a decrease in this type of activity attributed it partly to greater risks and closer management control.

25. Or has the development of interest rate futures in certain centres diverted some of this type of business from forward markets?

All Centres. Only a small minority of respondents said yes; the majority said no, or that they did not know. Those who reported some diversion said it had been small. Several banks said there had been no noticeable diversion yet suggested nevertheless that there might be in the future, if the business of futures markets developed further and became better known.

One bank made the point that if one were thinking, for instance, of the forward U.S. Treasury bill market, the participants are not the same as those in the traditional forward foreign exchange or the Eurocurrencies markets, at least as yet.

26. Have floating rates impaired the longer date forward markets, say beyond one year?

27. Have the larger banks concentrated more on the spot markets and would you agree that those smaller banks that specialized in longer date forwards until 1973 have tended to be squeezed out of business? If so, what would you say are the main reasons for such developments?

London. Two out of three respondents said the market for longer dated forwards had been impaired, but post-Herstatt rather than post-floating. This was linked to the answers to question 27; there was unanimous agreement that the bigger banks concentrate on the spot markets and that the smaller banks specializing in longer dated forwards had found their ability to do so impaired, even though they had not necessarily been squeezed out of the business. Longer dated forwards in some currencies are still obtainable for 5 and even 10 years, but not easily and only in limited amounts.

The reasons given included:

- while banks' own limits on spot and shorter forward transactions have generally been reinstated to pre-Herstatt levels, limits on longer dated forwards have not been similarly relaxed;
- Some greater caution has persisted since Herstatt about the acceptability of the names of smaller banks generally, including those specializing in longer dated forwards;
- the expansion in the capital base of many smaller banks has not been sufficient for an increase or even maintenance of longer dated forward business (or, alternatively, they have chosen not to use an enlarged capital base as backing for this particular activity);

- smaller banks have been reluctant to use credit lines with other banks for an expansion or maintenance of longer dated forward business.

In *Frankfurt*, *Zurich* and *Paris* the long-dated forward market has not been the speciality of smaller banks to the same extent as in London, partly because larger banks have included this specialization in their services to help finance exports of capital goods. So, although some smaller banks have been squeezed out of this market for the same reasons as given in London, the market has been less impaired by their withdrawal. Nevertheless, banks in Frankfurt and Zurich reported that this business had grown very little in relation to inflation and their other business, although in the case of German banks some of this business has been shifted from Germany to Luxembourg and London because of the backing afforded by the inter-bank foreign currency deposit markets for Deutschemark in Luxembourg and dollars in London.

Costs

28. Considering solely foreign exchange trading profits, and leaving aside foreign exchange earnings from loans and investments, have your trading profits increased in real terms (after taking account of inflation)?

29. If so, would you think that this has been the general experience of banks, once the market had overcome the dramatic losses associated with Herstatt and similar disasters?

All Centres. A majority reported an increase in their own profits; about half of them guessed that this has been the experience of other banks too, but the other half declined to express an opinion on that point.

However, all the banks which reported an increase in their real foreign exchange trading profits said it had been less than the increase in the real volume of foreign exchange trading since 1973, and several said it had been considerably less.* One bank observed that the overall increase in forex profits had been achieved despite a decline in the profitability of its forward trading since 1973.

Another point made was that while profits have tended to be higher in moving markets, so have risks and, in some cases, losses. Several banks ("other banks" in all cases) were said to have lost money in the markets of 1974 and 1978.

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*An illustration of very narrow foreign exchange trading profits on extremely high volume has already been given in the reference to the 1978 report of Bank Julius Bar.

A major international bank in London said it was uncertain whether the growth in real foreign exchange profitability could be relied on, at least at the pace of many recent years, because of the narrowing of margins to non-bank customers. Indeed, several banks pointed out there had been no steady trend in foreign exchange profits, which have tended to vary from year to year.

30. If your answer to 28 is positive, have the increased earnings been at the expense of customers or central banks?

Many banks (13) declined to answer this question, at least in writing; of those that did, ten said that increased earnings had been at the expense of central banks, four that they had been at the expense of both central banks and customers, and nine gave other replies.

Slightly more than a third of those who answered in *London* said the greater increase in foreign exchange profits had been on dealings with central banks; others said that it had been greater on dealings with non-bank customers or gave no clear answer.

One bank, however, actually quantified its answer, saying 80 percent of its foreign exchange profit growth since 1973 had been on transactions with central banks.

Several banks acknowledged that central banks were not in the business "mainly for profits"; that they often intervened for political reasons on instructions from their governments; but said that they did even that ineptly (in the view of some banks, as reported in the answers to questions 16 and 17).

Another bank observed that profits from central banks and customers were small in relation to those it made from taking spot and forward positions.

In *continental European centres* only a minority of banks claimed to have profited more from central banks than customers, a large bank in Frankfurt saying that central banks had, on the contrary, tended to be on the "winning side" since November, 1978. Another bank in Frankfurt said its foreign exchange profits came mostly from intensive arbitrage so that it was difficult to pin the "cost" of such profits on any single counterpart or class of counterparts. The latter point may have been a reason why many banks did not answer this question.

A majority of bankers in *New York* and the *Far East*, however, said that increased earnings had accrued, at least in part, from central banks.

31. In your view have floating exchange rates increased the costs of international trade and investment in real terms?

32. Have they made any contribution to inflation?

All Centres. A majority answered these two questions by saying yes, but minimally; "marginal compared with other engines of inflation" was one comment.

It was pointed out that companies do include the higher costs of more extensive foreign exchange cover (or risk) in their prices, whenever they are able; and that their readiness to increase export prices on a downward movement of their own exchange rate is not always matched by an equal readiness to reduce or even maintain export prices on an appreciation of their own exchange rate.

One respondent made the point that it was impossible to answer what "would have happened" under different circumstances, but added that matters would probably not have been very different under pegged but unstable rates than they have been under floating rates.

Survey of Market Opinion

2. The Survey of Industrial Corporations

The questionnaire reproduced below was mailed in July to selected major international corporations in the USA, Germany, France, the United Kingdom and Switzerland. Reports on the answers follow.

Questionnaire for Industrial Corporations

The following questions are designed to determine how floating exchange rates actually have affected the level of, costs of, and approach to international economic activity. The objective is to understand better the consequences of floating exchange rates; it is not to solicit preferences for the current regime versus the Bretton Woods system. Unless otherwise indicated, for each of the following questions, compare and contrast the current posture of your firm with that prevailing when most rates of exchange were fixed. As applicable, distinguish in your responses between floating rates *qua* floating rates and the highly volatile movements experienced over the past few years.

Policy

1. With floating exchange rates how has your firm's philosophy changed with respect to:
   (i) cash management;
   (ii) decisions regarding short-term portfolio investments;
   (iii) the principles employed in evaluating options to finance foreign operations;
   (iv) the attractiveness of investment abroad?
2. Has a formal statement concerning foreign exchange risks and opportunities been adopted by the firm? If one has, please attach a copy.
3. Has the firm become more or less averse to foreign exchange risks?

Management

1. Has responsibility for foreign exchange decisions become more centralized? If so, has the responsibility for other financial functions, e.g. cash and portfolio management, also become more centralized?
2. What is the relevant time horizon for foreign exchange decisions? Has it become longer or shorter? Is there heightened concern about the effects of foreign exchange fluctuations on reported interim financial results?
3. Does the firm distinguish between the translation and the cash flow effects of foreign exchange movements?
4. How are foreign exchange considerations reflected in project economics when evaluating an investment in another country?
5. How do you believe the financial community, i.e. commercial, merchant, and investment bankers, the investing public, professional portfolio managers, and the press, view the reported foreign exchange gains and losses of a firm?

Financial Strategy

1. Are floating exchange rates deemed by your management to represent a material new element of risk to international (i) trade and (ii) investment?
2. Have floating exchange rates resulted in the elimination, deferral, or reduction of any foreign direct investments?
3. Have floating rates rendered international trade more or less attractive? Have they, in fact, influenced the level of your international trade?
4. Have floating exchange rates raised the cost of conducting business internationally? If they have, in what ways and how is this increase measured?
5. Have your prices been raised to cover the incremental expenses of managing foreign exchange positions and hedging?
6. What factors are relevant when selecting the currency of borrowing?
7. Have you increased or decreased your borrowing of foreign currencies? Have you become less or more willing to borrow foreign currencies long-term?
8. Regarding the currency of denomination for sales to (i) affiliates and (ii) third parties,
   (a) What factors are relevant in selecting the currency?
   (b) What percentage of your exports and imports are denominated in the currency of (i) your home country, (ii) the importer's country, and (iii) another one (Specify the most important one[s])? To what extent has the currency of denomination for international trade changed over the past six years?
   (c) Some academicians argue the currency of denomination is irrelevant because market forces will preclude any supplier or customer from using this aspect of a contract to extract a consistent gain over time. Do you agree or disagree; why?
9. With floating exchange rates, capital and trade controls should be both less prevalent and less restrictive. Has this been your experience or do restrictions continue to inhibit the free flow of money and goods?
10. Have you, as a result of floating exchange rates, taken any decisions to achieve a desired accounting result and sacrificed an economic gain?

11. What new tools, devices, and techniques in international finance have developed in the last few years?
    Do you use more frequently today some of the financial techniques e.g. swaps, parallel loans, leading and lagging etc. which predate the collapse of fixed foreign exchange rates?
12. What economic and other factors are considered when forecasting foreign exchange rate movements?
13. Are the foreign exchange markets "efficient," i.e. the price of a currency at any time reflects the combined knowledge of market participants and is a good estimate of its intrinsic value?
14. Do you believe you (or your advisors) can consistently predict future foreign exchange rate movements more accurately than "the market"?

Reports on Answers to the Questionnaire

Policies

1. With floating exchange rates how has your firm's philosophy changed with respect to:

   (i) cash management;
   (ii) decisions regarding short-term portfolio investments;
   (iii) the principles employed in evaluating options to finance foreign operations;
   (iv) the attractiveness of investment abroad?

While responses varied, it was generally agreed that floating rates have led corporations to become more sensitive to the effect of currency movements, particularly on their *short-term* financial operations. About half of the respondents said that their philosophy toward cash management and short-term portfolio investments had changed as a result of the volatility of exchange rates and the changing structure of the international capital markets. Foreign exchange considerations were taking an increasing amount of management time International financial management had improved substantially with the growth in the number of experienced personnel and more sophisticated equipment.

Those respondents who believed that floating rates had not changed their philosophy toward cash management nevertheless felt that floating rates had altered the pattern of their short-term portfolio investments, which had become more biased toward the Eurocurrency market. For some respondents, foreign exchange considerations had become the dominant factor when making portfolio investment decisions; relative rates of interest had assumed a secondary role.

Few respondents felt that their approach to the finance of foreign operations had been significantly changed by floating rates though there appears to be a greater emphasis on local currency financing, as well as more activing leading and lagging of trade payments, and selective hedging of foreign exchange exposure.

Respondents agreed unanimously that overseas investment policy had not been significantly affected by the advent of floating rates. Those respondents in the petroleum industry commented that floating rates had had a relatively minor effect on investment abroad because the oil industry remains dollar-based. One American respondent stated that the attractiveness of foreign direct investment had declined as the dollar weakened and as manufacturing costs (in dollar terms) in other industrial countries rose above those in the U.S.

2. Has a formal statement concerning foreign exchange risks and opportunities been adopted by the firm?

Fewer than half of the respondents have adopted formal statements on foreign exchange management. Those corporations without formal statements have policy guidelines for the corporate or financial officers responsible for foreign exchange transactions.

3. Has the firm become more or less averse to foreign exchange risks?

Some respondents stated no change in their attitude toward this type of risk but a small majority said they had become more averse, especially for the short term in which there is much greater exposure to volatile fluctuations.

Management

1. Has responsibility for foreign exchange decisions become more centralized? If so, has the responsibility for other financing functions, e.g. cash and portfolio management, also become centralized?

A number of firms have for some time centralized responsibility for foreign exchange and portfolio management in headquarters. To the extent that foreign affiliates had a measure of discretion in the past, there is a tendency toward centralizing certain financial functions. Complementing this trend, there also has been a movement toward greater consolidation of international treasury functions.

2. What is the relevant time horizon for foreign exchange decisions? Has it become shorter or longer? Is there heightened concern about the effects of foreign exchange fluctuations on reported interim results?

Most respondents stated that their planning horizons for transactions purposes have become shortened as a consequence of the increasing unpredictability of exchange rates. All American companies reported increased concern, or at least awareness, about the effects of foreign exchange fluctuations on reported interim results.

3. Does the firm distinguish between the translation and the cash flow effects of foreign exchange movements?

All firms differentiate between economic exposure and translation exposure. Differences arose between the strategies each respondent employed to manage cash and translation exposures. One respondent reported that forecasts are made "to anticipate future exposures of both a translation and cash flow nature," after which an evaluation is made of the effect of cash flow hedging decisions on translation exposure. Respondents regarded actual cash losses as more serious than translation losses. Nonetheless, two U.S. respondents suggested that under certain conditions they have been willing to "risk cash losses in order to offset potential translation fluctuations."

4. How are foreign exchange considerations reflected in project economics when evaluating an investment in another country?

Most respondents agreed that foreign exchange assumptions are an integral part of long-term project economics. Other things being equal, the sensitivity of the project to various exchange rate assumptions is evaluated against profitability, cash flow, and other financial measures in both home and local currency terms.

One respondent suggested that the risks inherent in foreign investment (of which foreign exchange is just one) required higher *premia* which should be reflected in more stringent investment criteria or higher hurdle rates for international projects. Also, respondents frequently mentioned the importance of assessing the effects of various foreign exchange restrictions on investment flows.

The evaluation of an investment project solely in terms of local currency was suggested by only one respondent. The same respondent commented that floating rates have contributed to a distortion in the pattern of their investment.

5. How do you believe the financial community, i.e. commercial, merchant and investment bankers, the investing public, professional portfolio managers and the press view the reported foreign exchange gains and losses of a firm?

Nearly all respondents felt that there was a great deal of confusion about the significance of foreign exchange transactions. Many respondents trace part of the lack of public understanding to the press. Abnormally large gains or losses, often related to currency fluctuations rather than business decisions or speculative behavior, frequently attract attention in the media.

Financial Strategy

1. Are floating exchange rates deemed by your management to represent a material new element of risk to international (i) trade and (ii) investment?

There was strong agreement among respondents on this question. Although floating rates had added a "new dimension" of risk (or uncertainty) to both trade and investment, few deemed the added risk to be material and in either case it was the volatility which was constantly reiterated as the damaging element, rather than floating rates per se.

One respondent bluntly stated that "sudden changes during the fixed rate era represented a more risky environment than the more or less smooth movements in today's system."

A particularly significant result was that, on the issue of investment, the larger degree of perceived risk had not, in the opinion of respondents, actually discouraged foreign investment.

2. Have floating exchange rates resulted in the elimination, deferral, or reduction of any foreign direct investments?

All respondents answered in the negative; floating rates had *not* led corporations to abandon or reduce foreign direct investment.

3. Have floating rates rendered international trade more or less attractive? Have they, in fact, influenced the level of your international trade?

Respondents believed that floating rates had had a negligible impact on the level of their foreign trade.

4. Have floating rates raised the cost of conducting business internationally? If so, in what ways and how is this increase measured?

The general view was that floating rates had not appreciably raised the costs of conducting business internationally. Some respondents who took this view added qualifications, however. One said that they had altered the pattern of costs and made them, to some extent, more volatile, another that they had probably raised costs in the short run, in view of the need to protect exposures—but that on the premise that exchange markets would have experienced even larger one-time adjustments without floating rates, the cost had probably not increased materially.

A minority took the view that costs had increased, the main factor being the cost of increased hedging. One respondent from Germany said that as a company based in a hard currency country the cost had definitely increased, though the increase could not be measured greatly. Another multinational corporation, based in the United Kingdom, said that the only costs involved had been in setting up and staffing an exposure management team and the greater management time devoted to foreign exchange matters. But again, the latter was probably more related to exchange rate volatility than to floating rates.

5. Have your prices been raised to cover the incremental expense of managing foreign exchange positions and hedging?

Most replies were in the negative. This result should, however, be interpreted with care, in view of the impression given by replies to other questions that hedging of foreign exchange exposure is a much more widespread practice than was the case before the advent of floating rates. Indeed, several respondents began their reply by stating that the cost of forward cover is a part of normal business costs, before going on to say that prices are determined by competitive conditions in the relevant markets.

6. What factors are relevant when selecting the currency of borrowing?

"Primarily cost on an all-in basis: that is to say, interest plus exchange risk." This reply from a UK-based multinational reflected the view of the majority of respondents. One said that they would include the aftertax cost of forward cover "unless the currency was considered to be chronically weak." Some said that they tried to match currency liabilities and assets, but the general impression given in the interviews was that many corporations only pay lip-service to this concept. During the past dozen years, exchange-rate movements have nearly always overwhelmed the interest-rate differentials between appreciating and depreciating currencies. As a result, many companies now attempt to finance international investment, whenever possible, in weak currencies, inhibited only partly by taxation of exchange-rate gains, where applicable.

7. Have you increased or decreased your borrowing of foreign currencies? Have you become less or more willing to borrow foreign currencies long-term?

Most US corporations said they had reduced their borrowing of foreign currencies, especially long-term. Respondents in strong-currency countries said they had become more willing to borrow abroad, both short and long term. Many added that their decisions had not been affected by floating exchange rates.

8. Regarding the currency of denomination for sales to (i) affiliates and (ii) third parties,

(a) What factors are relevant in selecting the currency?

(b) What percentage of your exports and imports are denominated in the currency of (i) your home country, (ii) the importer's county, and (iii) another one (Specify the most important one[s])? To what extent has the currency of denomination for international trade changed over the past six years?

(c) Some academicians argue the currency of denomination is irrelevant because market forces will preclude any supplier or customer from using this aspect of a contract to extract a consistent gain over time. Do you agree or disagree; why?

Answers to these questions varied considerably, depending on the prevailing practices and market conditions of a given industry. The sample was too small to allow general conclusions to be drawn about trends in invoicing policy, with one exception. This is that where companies have sufficient freedom of choice, they try to invoice in strong currencies as far as they can. This applies not only to exporters in strong currency countries, which in most cases appear to have been remarkably successful in maintaining the proportion of their exports invoiced in their domestic currencies, but also to other multinational corporations. It is true that the choice of currency for the invoicing of sales abroad is not determined in all cases by hopes of obtaining a price advantage; a British international company, for instance, reported having followed a consistent policy of invoicing most of its exports, made through foreign subsidiaries, in the currencies of the importing countries. But, whatever its motives, about 85 percent of its exports are invoiced in currencies other than (and historically mostly stronger than) sterling, which is the exact reverse of domestic currency invoicing reported by companies based in strong-currency countries.

In this respect companies appear to disagree with the academic argument in their invoicing policies. Although there may be no price gain from strong-currency invoicing over the long run, there is often a gain in the short-run. Moreover, price increases are thought to be more acceptable to importers when attributable to larger forces, like exchange rate alterations, than when they are attributable to the exporting firm alone. Put another way, strong currency invoicing is thought to provide a temporary gain, or at least respite, before international competition produces price adjustments offsetting part or all of the exchange rate changes.

9. With floating exchange rates, capital and trade controls should be both less prevalent and less restrictive. Has this been your experience or do restrictions continue to inhibit the free flow of money and goods?

Some said that their experience supported the view that capital, and, to a lesser extent, trade controls had become less prevalent and less restrictive. However, most respondents appeared to be disappointed that floating rates had not led to a greater degree of liberalization, and some said that they had not seen any easing in capital and trade controls—except in the case of the United Kingdom, where greater freedom is properly attributed to developments other than those in the foreign exchange market.

10. Have you, as a result of floating exchange rates, taken any decisions to achieve a desired accounting result and sacrificed an economic gain?

Most said they had not taken any such decisions. One US respondent pointed out that balance sheet cover, under certain circumstances, could be construed as achieving an accounting result while sacrificing an economic gain; another said that his company had not hedged book exposures with regard to the economic cost of such actions; but another said that the combination of floating exchange rates and FAS 8 accounting rules had caused his company to incur an economic loss.

11. What new tools, devices, and techniques in international finance have developed in the last few years? Do you use more frequently today some of the financial techniques e.g. swaps, parallel loans, leading and lagging etc. which predate the collapse of fixed foreign exchange rates?

No corporation reported the development of new financial techniques to cope with the risks of floating foreign exchange rates. However, most acknowledged they had employed more frequently established methods of protecting themselves against loss or seeking to achieve a profit. These included more frequent use of swaps, parallel loans, forward exchange markets and fully-hedged multicurrency financing options.

12. What economic and other factors are considered when forecasting foreign exchange-rate movements?

A host of economic and political factors were mentioned in answers to this question. The emphasis remained firmly on differential inflation rates for medium and long term forecasting, and on market sentiment in the short term.

13. Are the foreign exchange markets "efficient," i.e. the price of a currency at any time reflects the combined knowledge of market participants and is a good estimate of its intrinsic value?

All respondents stated, in effect, that, in the words of one of them, "the price of a currency does reflect the combined knowledge of most participants at a given time but, it is not necessarily a good estimate of the currency's intrinsic value" or, as another said, "Much of the 'combined knowledge' is misinformation or guessing that is frequently exaggerated by the latest news, good or bad, for the currency."

14. Do you believe you (or your advisors) can consistently predict future foreign exchange-rate movements more accurately than "the market"?

No one claimed that he could, but all of them try. Many agreed with those bankers who said that the forward rate is not a predictor of future spot rates, but a reflection of interest rate differentials.

Some respondents implicitly based their policy of selective hedging on the claim that they, or their advisors, can forecast exchange rate movements more accurately than the forward markets in many cases. They can certainly be mistaken and an example was provided in the course of one interview. A corporate treasurer said he had formed a strong view about the outlook for his country's currency and had acted on that view. A week later, his view was disproved in the markets. Nevertheless, the claim of corporations that they can often outguess the forward markets is a credible one. So long as foreign exchange forecasts are on the right side of the forward market in identifying currencies as being over or under-valued in terms of their forward quotations, the "advice" conveyed by the forecast will be right even when the forecast itself is wrong. A view of exchange rate trends can prove useful in practical terms without being able to forecast precise exchange relationships. That may explain the willingness of companies to hedge selectively.

Officers of the Group

H. Johannes Witteveen	Chairman
Robert Pringle	Executive Director
Geoffrey Bell	Executive Secretary
Robert Solomon	Treasurer

Two World Trade Center
Suite 9630
New York, New York 10048
Tel: (212) 775-9160

Group of Thirty

The Group of Thirty was established in December 1978, in order to explore the basic problems in the functioning of the international economic system. It meets twice a year, for two to three days at a time. Between these meetings, study groups and researchers gather material to serve as the basis for the Group's discussions.

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Balance-of-Payments Problems of Developing Countries

A report by a study group of the Group of Thirty

Jacques J. Polak	Chairman of study group Executive Director, International Monetary Fund
Roberto Campos	Brazilian Ambassador to the United Kingdom
G. A. Costanzo	Vice Chairman, Citibank
Carlos F. Diaz Alejandro	Yale University
David Holland	Chief Adviser, Bank of England
Cesar E. A. Virata	Secretary of Finance, The Phillippines
H. Johannes Witteveen	Chairman, Group of Thirty
D. Joseph Wood	Director, FPA, World Bank
Robert Pringle	Executive Director, Group of Thirty

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Balance-of-Payments Problems of Developing Countries

The Imbalance in External Payments

1. The further surge in oil prices in 1979-80 has dramatically increased the scale of international payments imbalances. The oil-exporting countries ran a combined current account surplus of about $115 billion in 1980, requiring the rest of the world to run a deficit of the same magnitude. Non-oil developing countries have been hit particularly hard. They have had to contend not only with much higher oil bills (net oil imports of oil-importing developing countries rose by some $40 billion from 1978 to 1980) but with two other inter-related changes in their external environment: first, the slowdown in the industrialized countries, which provide their main export markets; and secondly, the move to positive real interest rates, which has raised the real cost of borrowed funds. Both factors have tended to raise their current deficit further and to reduce their debt-servicing capacity. The combined current account deficit of non-oil LDCs totalled some $80 billion in 1980 and could rise further this year, possibly approaching $100 billion. As the International Monetary Fund's "World Economic Outlook" stated last year, the projected deficit of non-oil LDCs is all the more worrying because it is coupled with virtual stagnation in the volume of imports. These countries are therefore confronted with a new threat to their growth, a threat that is almost certainly greater than that in 1974, after the first oil shock.

2. Admittedly, it is possible that OPEC's surplus will again diminish more rapidly than most observers presently anticipate, as it did in 1974-76. This could take place as a result of a deepening and prolongation of present recessionary tendencies, and signal a failure of the world economy to adjust satisfactorily to the increase in the real price of oil; or it could

result from a rapid growth in OPEC imports in conjunction with an unchanged or lower real oil price. On other assumptions, however, OPEC's annual surplus might be maintained at very high levels for a number of years; the surplus will certainly be underpinned by the rapid growth in earnings on OPEC's accumulated financial assets. It would not be surprising if the surplus were to be still in the range of $40-$50 billion in the mid-1980s. But the function of such scenarios is not to forecast future developments, but to illuminate the issues and dilemmas facing policy makers. They also underline the extreme uncertainty of the present outlook.

3. It remains important, in this context, to keep the size of the non-oil LDC deficit in perspective. In connection with the payments desequilibria caused by the 1973-74 oil price increases, the IMF calculated that the growth of the deficit, from about $8 billion a year in 1967-72 to some $30 billion in 1977, was in no sense disproportionate if one took account of the growth in real economic activity and the rise in world trade prices over the period. A somewhat similar perspective is called for as the world faces again disequilibria of unprecedented size. In the five-year period from 1974 to 1979, the LDCs have experienced a real growth of about 5 per cent per year and world prices of manufactures in terms of U.S. dollars have increased by at least ten per cent per year. Such a conjunction of quantity and price increases produces a doubling of value figures in about five years. Thus, figures for current account deficits for the LDCs that are foreseen for the early 1980s are not by themselves markedly out of line with the figures of half a decade earlier.

4. Whether inflows of capital—much of it on a commercial basis—can be economically sustained on such a scale is not, in the first instance, a question of their size by itself; it depends on the use made by developing countries of the total resources, domestic and foreign, at their disposal. Critical questions in this connection are the behavior of the savings ratio in the country, the improvement in the ratio of energy use to GNP, and the development of net external indebtedness to GNP. These are questions to be considered on a country-by-country basis. (In many individual cases, there may be little scope, for instance, in an improvement of energy use to GNP). They relate to the success that the country has made of its adjustment to the higher cost of energy and the declining growth rate in the industrial world. The more adverse the external conditions in which developing countries have to operate their economies, the greater the policy adjustments that will be required from them to maintain a strong rate of growth and to be creditworthy—in the basic economic sense of that word—for large capital flows.

The Mix of Adjustment and Financing Policies

5. Whether or not the non-oil LDCs will be able to sustain their growth rates in the 1980s will depend primarily on three factors: first, on the willingness and ability of these countries to adjust their policies to the new circumstances, given the widely-differing situations and natural growth potentialities of individual countries; secondly, on the policies adopted by the OECD countries; and thirdly, on the ability of the financial system to support suitable policies and programs by the provision of finance on the required scale and at acceptable terms. We will briefly consider each of these.

(a) Policies for developing countries

6. The ability of many developing countries to sustain growth in the 1970s, partly due to considerable improvements in their standards of economic management, provides some grounds for confidence in their ability to weather successfully the even harsher climate of the 1980s. Where the large current deficits which non-oil developing countries have run for many years found their counterpart in increased domestic investment, they are not a measure of distress; on the contrary, they are indicative of the success of these countries' economic policies. On the side of the supply of international capital, they reflect the greatly-expanded ability of the international banking system to permit, and even encourage, a much larger transfer of real resources than would have been possible even 15 years ago. It is banks' willingness to lend and the ability of many non-oil LDCs to use the funds productively, as much as OPEC's action in raising oil prices, which created the conditions in which imbalances on the present scale can arise and persist. Without such a mechanism, OPEC's attempt at raising oil prices would not have produced large payments surpluses, but would merely have pushed the world into a deep depression.

7. In present circumstances, several different concepts of "adjustment" may be distinguished. One concept refers to the adoption of policies to deal selectively with the particular problems caused by the further rise in the cost of imported oil—notably energy conservation and the development of alternative sources of energy. (Fortunately, several developing countries outside OPEC have since 1973 become net oil-exporters themselves and others have prospects of becoming largely or wholly self-sufficient). A second approach refers to the need for countries to adopt suitable macro as well as micro-policies to deal with the changes in their environment—notably the prospective slowdown in OECD growth rates and the change in relative prices—even if their policies had been quite

appropriate in the previous situation. A third concept relates to the need for countries to adjust policies—such as excessive government deficits or overvalued exchange rates—that would bring about payments difficulties in any circumstances. Traditionally, the International Monetary Fund has focused on the third category and such adjustment continues to be essential where basic policies are defective. In present conditions, however, the other concepts of adjustment are relevant over the entire spectrum of developing countries.

8. The adjustment programs to be chosen by different countries, and the mix between adjustment and financing, will vary widely. All countries are confronted with the need to effect structural changes in their economies in reaction to the steep increase in the real cost of energy; some may be able to effect these changes while maintaining rates of economic growth that are high by historical standards; others will have to apply longer-lasting restraints on demand, and to scale down their development plans; some will need to attend urgently to the correction of policies that would be inappropriate in any circumstances. It is neither possible nor desirable to prescribe general rules applicable in all circumstances. Purveyors of credit (aid-giving countries, commercial banks, the IMF and the World Bank) will need to realize, in their lending policies, the wide diversity of country situations and the consequent need for divergencies in adjustment policies.

9. It is clear that the oil-price shock puts a premium on high standards of economic management. In general, countries which give high priority to creating the conditions necessary to increase the total flow of savings (domestic and external) available to them will have the best chances over time of resuming previous growth rates. Given the remarkable flexibility demonstrated by several fast-growing LDCs in the 1970s, it is not out of the question that some countries will in this way, and in even more adverse circumstances, be able to accomplish adjustment through growth. Other countries will find it difficult or impossible to accomplish successful adjustment in this way, particularly where pressure to maintain previous rates of growth in real incomes is strong. Adjustment will often require far-reaching changes in the patterns of output and trade; action to improve the functioning of markets and the price mechanism; the reform of taxation policies and the management of public expenditure; the adoption of new energy policies; the removal of obstacles to efficient investment, whether foreign or domestic; and possibly a variety of other measures to hold down levels of consumption and mobilize savings.

(b) Policies for Industrial Countries

10. With regard to the major industrial countries, the emphasis of demand policies at present is placed on the need to maintain the struggle against inflation. The policy response to the second oil shock was shaped by the main lesson drawn from the first oil shock, namely that countries which acted in practice promptly to effect their adjustment also adjusted more successfully than others. There is still some dispute, however, as to whether this was indeed the right lesson—still less the only one--to be drawn from that experience. It would certainly not be correct to interpret this lesson as requiring the adoption of policies aimed at eliminating the payments deficits of the industrial countries. The main effect of the adoption of such policies would be to raise further the deficits of the non-oil LDCs. The effect on global payments current imbalances would be small. On the other hand, the need to avoid a cumulative round of belt-tightening should not become a pretext to avoid or postpone adjustment to the real loss of income brought about by the adverse movements in terms of trade. The posture of fiscal and monetary policies should be guided by the need to reduce inflation over the medium term.

11. An important fact in this connection is that the large industrial countries have generally found means of financing their payments deficits without major difficulties. In particular, Germany and Japan, which together accounted for a large fraction of the industrial countries' current account deficit for 1980, made arrangements for financing their payments deficits at least partly by means of capital inflows denominated in their own currencies. These transactions indeed provided oil-exporting countries with opportunities to diversify the currency composition of their foreign assets.

12. Although earlier fears of a deep world-wide recession have so far proved unfounded, it is still worth emphasizing that the present recession, if prolonged, will have increasingly severe effects on the LDCs; in particular, an additional share of the aggregate deficit is being shifted to the non-oil LDCs, so that they now bear a very large proportion of the total. As economic growth in the industrial countries in 1981 is likely to remain sluggish, possibly at only about 1 per cent, this process could still force the non-oil LDCs into such harsh measures of adjustment as to put back their development for a long time. In making their plans on how to deal with their economic difficulties, the large industrial countries should bear in mind such risks of the system, and be careful about the world-wide shock waves that sharp deflationary policies on their part might set off.

13. In an environment of sluggish growth and rising unemployment, several industrial countries are likely to come under increasing pressure from domestic sectional interests to adopt protectionist measures. In such a climate, it is particularly important that they should resolutely resist such pressures. Protectionist measures would bear very heavily on LDCs and would defeat the adjustment action that many of these countries have been taking, at great political and social cost to themselves. Such measures would indeed be particularly damaging precisely to those countries that have been trying to adopt outward-looking policies, and which are therefore most vulnerable to a further deterioration in the prospects for world trade. For an industrial country or group of countries to step back from the open trading principles that they have undertaken to follow, and enjoined on developing countries, would be regarded as an act of betrayal. By giving the wrong signals at the wrong time, it would also jeopardize the entire structure of the world's open trading and currency arrangements constructed with such difficulty over the years since World War II.

14. Assuming that they steer clear of such self-defeating and dangerous means of coping with their difficulties, individual industrial countries, like developing countries, will select differing mixes of "adjustment" and "financing". Certainly, the three concepts of "adjustment" outlined in paragraph 7 are as relevant to them as to the developing countries. However, as industrial countries consume a very large proportion of the world's production of primary energy, perhaps their greatest contribution to an alleviation of the present strains in the international economic and financial system lies in measures to conserve energy and encourage new sources of production. It is now generally recognized that domestic energy prices should be allowed to rise at least to international market levels. Beyond this, the fact that the common interest in reducing energy demand and increasing supply exceeds the sum of individual national interests provides itself a strong justification for collaborative arrangements to further these objectives.

15. In another area of policy, governments and central banks in the major industrial countries should do whatever they can to facilitate access by LDCs to their capital and money markets. They should review existing regulatory or informal constraints, particularly those which have the effect of limiting access to bond markets. They should avoid the imposition of restraints on the international operations of their commercial banks and other financial institutions for balance-of-payments reasons. Countries

with well-developed money and capital markets, in particular, should encourage greater two-way flows of capital (financing longer-term outflows by shorter-term inflows), allowing some of the "maturity transformation" currently effected by banks to be effected in other ways, e.g. by inflows into government paper and outflows through direct or portfolio investment.

Finance Through the Market

16. As in the 1970s, the principal channel of intermediation for the higher income LDCs will be provided by the commercial banks. The flow of market financing will, however, continue to be subject both to "external" and "internal" constraints. The first concept refers to banks' readiness to extend further credit, and depends crucially on the effectiveness of the measures countries take to maintain their creditworthiness. The second concept refers to "prudential" constraints on banks' ability to increase their lending and includes, for this purpose, rules imposed by bank managements and by bank supervisors.

(a) The role of creditworthiness

17. As explained above, some fortunately-placed countries may be able to maintain their creditworthiness without sacrificing growth and in our view market finance will generally be available to such countries provided they adopt the policies that are required to make this approach effective. Others will have to accept restraints on growth—whether temporary or longer-lasting. In all cases, financing and adjustment should go together. Developing countries which act most promptly and effectively to improve their performance (in accordance with the requirements of their situation referred to in paragraph 8) will be able to command a larger volume of financing and be able to run larger deficits later than those that delay such action. Countries that avoid adjustment as long as possible and resort to the maintenance of consumption by financing will ultimately—even if the requisite finance is forthcoming in the short term—weaken their creditworthiness and be forced to an even more painful adjustment in less favorable circumstances. Thus, the relative strength and promptness of the measures adopted by different countries—together with their native resource endowments—will largely determine the distribution of the available financing. However, even the prompt adoption of appropriate policies will bear fruit only over a much longer period than has typically been the case with adjustment programs in the past. So longer-term financing will also be required.

18. Since banks' readiness to extend further credit depends on their judgment about individual countries' ability to service the debt, they will also take into account existing levels of indebtedness. The outstanding public and publicly guaranteed medium and long-term external debt of non-oil developing countries at end-1979—close to $250 billion—was well over three times the total at the end of 1973; as a proportion of estimated aggregate GDP, it had risen from less than 14 per cent to 18½ per cent over the period (IMF "World Economic Outlook", May, 1980). At end-1979, about half the total was owed to private creditors. However, thanks to the rapid increase in export earnings of non-oil developing countries, the rise in annual interest payments has not greatly exceeded that in export receipts. Including estimates for private medium-term debt, the overall debt service ratio (to exports) of non-oil LDCs has increased from about 12 per cent in 1973 to 15 per cent in 1980. The ratio changed little in the two years to end-1979; and the significance of any particular debt service ratio is debatable. Although banks will clearly continue to be selective in their loan policies, there is little reason in our opinion to fear that modest increases in recorded debt service ratios are likely in themselves to inhibit lending to non-oil LDCs that maintain their creditworthiness by means of policies such as those outlined above.

b) "Internal" constraints on bank lending

19. Turning to "internal" constraints, at present there are widespread doubts about the ability of banks to assume as large a share in the recycling of the surplus OPEC funds as in the past. These relate to concerns over capital adequacy; portfolio limits and the concentration of bank lending to a few countries; and the changing attitudes of supervisory authorities. Due to these influences, and prospects for greater competition for funds from OECD countries and possibly China, financial markets are expected to become tighter and borrowing conditions less favorable; thus far, a few LDCs have faced a substantial tightening of terms, though others are still able to borrow on very fine terms. The Study Group is conducting a survey of opinion among leading bankers to enable it to form a judgment on these issues; the following remarks offer some provisional comments.

20. The evidence examined by the study group thus far suggests that these "internal" constraints will not be so restrictive as to prevent a continued rapid growth in lending to developing countries. According to projections made by the IMF, quoted in a speech by the Managing Director, market growth of 20-25 per cent in 1980 and 1981 would yield net international banking flows broadly in line with aggregate borrower demand.*

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*Address to the Federal Association of German Banks, Bonn, October 29, 1980.

This is below the average growth in international bank lending during the last decade. Both the scale of imbalances and the incremental demand for private finance are smaller in relation to the size of the markets than was the case in 1973-74. The study group has not been able to find firm evidence to support the view that capital ratios of international banks in general have deteriorated markedly, or that concentration of lending in a few countries will inhibit the aggregate flow of finance. True, individual borrowers may be affected–that is the function of such constraints. Such countries should seek opportunities to diversify their sources of finance. But as Mr. de Larosière pointed out in the speech mentioned above, taking the banks in the BIS reporting area as a group, neither the share of loans to non-oil LDCs in banks' gross external assets nor the share represented by the dozen largest borrowers has increased in the last several years. The outstanding debt of banks to non-oil developing countries of $190 billion was equivalent to only about 4-5 per cent of total bank assets at the end of 1979.

(c) Market imperfections

21. Other concerns relate not so much to the readiness or capacity of the markets to cope with a substantial further rise in international lending but rather to imperfections in the operations of the markets. For instance, from time to time marked fluctuations have been observed in the credit activities of the commercial banks vis-a-vis the developing countries. At times, commercial banks, spurred on by competition, may lend excessively to certain countries, based on an unduly optimistic appraisal of their prospects or particularly favorable short-term profit opportunities. Some years later, they may suddenly cut back their credits as clouds gather over a country's prospects. Another aspect of this kind of behavior is the tendency for the maturities available in the market to change somewhat abruptly, resulting in a "bunching" of amortization payments due in some years. Such waves of optimism or pessimism can exacerbate the financing difficulties of developing countries as a group, and they can lead to acute difficulties in the case of individual countries.

22. It is important in this area to distinguish the basic operating mechanism of credit markets from the imperfections of these markets. As long as a large part of the flow of capital reaches the developing countries through the banking system, this flow will depend on the banks' views as to what are safe and profitable lending opportunities and the actions of the countries concerned to maintain their creditworthiness. In the relation between the IMF and capital importing countries, there can be direct

negotiation on policies; no comparable mechanism is available between the bankers and the same countries. Perhaps as a result, the market may at times operate in an unduly abrupt way. But, whatever the imperfections and the lack of smoothness of credit markets, these markets perform a basic function. The mechanism of these markets does convey to governments the broad views of the banks on the appropriateness of prevailing policies from the point of view of countries' creditworthiness. Moreover, governments themselves are quite often well aware of policy changes that are called for.

23. The need for futher improvement of the means of communication between the banks and governments of borrowing countries underlines the importance of a continuing flow of authoritative information and analysis about the economies of these countries, and in our view international institutions can play a valuable role in this regard, as outlined below. Moreover, the increasing tendency for the commercial banks to suggest that countries in difficult circumstances enter into policy discussions with the Fund should serve to improve the functioning of the international credit mechanism.

24. Another worry, often expressed but rarely defined precisely, relates to the possibility of some kind of "breakdown" in the recycling mechanism. A break in confidence could arise from a variety of circumstances, some of which may have no connection with LDC indebtedness. But if a number of large or medium-sized debtors were to request debt restructuring within a short period, and interest payments on outstanding debt were to fall below the cost of carrying these loans to the banks, the possibility of a break in confidence would clearly be increased. Heightened uncertainty, reflected possibly in magnified form in the interbank market, could lead to the withdrawal of deposits from banks believed to have large loans (in relation to their total balance sheets) to the country or countries concerned and an atmosphere of "contagious mistrust" engendered. Even in the absence of a "discontinuity" in the interbank market, a debt moratorium by a large borrower—or simply a perception that political risk had increased—would result in more stringent conditions and terms being applied to other borrowers, and possibly to new international loans in general. In a mild form, this indeed was witnessed in 1980, as a result of the revolutions in Iran and Nicaragua. In a wider crisis, there might be a danger of a cumulative process being set in motion which, once under way, might be very difficult to bring under control.

25. True, it is unlikely that any large borrower or group of countries would deliberately take measures that would have the effect of imperilling their creditworthiness. The stake that borrowers have in their continued access to market finance provides a powerful buttress to the continued orderly functioning of the international banking system. Borrowers can be expected to make every effort to maintain at least their interest payments on outstanding debt, even in very difficult circumstances. In the future, as in the past, a number can be expected to request a restructuring of their debt payments, but again this will usually be effected by negotiation with creditors.

26. Nevertheless, in view of the magnitude and speed of recent movements in payments imbalances, and the degree of "maturity transformation" required of the banking system, it would be foolish to deny the possibility, however remote, of a breakdown in the recycling process. On our view, it is an inherently unsatisfactory characteristic of the system that it relies heavily on the "transformation" by banks of short-term deposits into effectively long-term loans; but given the preferences of OPEC depositors and of LDC borrowers the problem is not likely to go away. Also, in the context of volatile oil prices, sluggish growth in the industrial countries and high interest rates, pressures exerted through the markets on borrowers for early progress towards adjustment of payments imbalances may become so acute as to be politically or socially intolerable. In short, there are default risks in international lending; in our view, these risks are increasing.

(d) Prudential supervision

27. The responsibility for providing official mechanisms for the system, to maintain confidence, rests with central bankers on the one hand and the International Monetary Fund on the other. With respect to the former, we recognize the progress made in cooperation amongst central banks and bank supervisors in recent years. The confidence crisis following the failure of the Herstatt bank in the summer of 1974 led directly to the statement issued by the Bank for International Settlements later that year, which, inter alia, stressed the importance that the Governors attached to effective supervision. Further work led to the so-called "Concordat" of 1975, which laid down in some detail the principles on which responsibility for the supervision of bank branches, subsidiaries and consortia should be allocated as between home and host countries. Since then the banks, in cooperation with national supervisory authorities, have moved to strengthen standards of bank management further, and a continuous exchange of views among authorities has taken place in the Committee on Banking Regulations and Supervisory Practices (the "Cooke Committee").

28. These consultations were reflected in the press communique issued by central-bank Governors of the Group of Ten and Switzerland on April 15, 1980. This emphasized the high priority the Governors placed on bringing into full effect the initiatives already taken by the Committee on Banking Regulations and Supervisory Practices with regard to the supervision of banks' international business on a consolidated basis, improved assessment of country risk exposure, and the development of more comprehensive and consistent data for monitoring the extent of banks' maturity transformation.

29. In our view, it is clear that central banks can function as credible lenders of last resort to the system only if they equip themselves to judge the prudence with which individual banks conduct their business; and the knowledge that supervisory authorities take an active interest in the soundness of the banks under their guidance constitutes a valuable contribution to the soundness of the system as a whole. On the other hand, bank supervision should not be used as an instrument to regulate the aggregate volume of international lending. Supervision should lead to the establishment of widely-agreed prudential guidelines; it should involve exchanges of information between bank supervisors; and it should also provide for cooperative procedures to defuse a crisis. Beyond these areas of agreement as to the scope for the supervision of the banks' foreign lending activities, discussion revealed a range of opinion. One view is that supervision could encompass the establishment of individual country debt limits where this seemed necessary to the supervisors; others maintain that banking supervision is a matter of ensuring prudential behavior by individual banks and that it is in this context that supervisors' interest in appraising country risk should be placed; others hold the view that even this would involve unwarranted interference both with the banks' own responsibility for the quality of their loan portfolios and with the effective working of the recycling process. Another study group of the Group of Thirty is examining this and other aspects of banking supervision and risk.

30. From time to time, bankers and their customers in developing countries have expressed concern that unnecessarily "fussy" regulations could hamper the smooth operation of the recycling process. In general, national supervisory authorities should bear in mind the probable repercussions of new regulations and guidelines, even where these are aimed primarily at strengthening their domestic banking structures, for inter-

national financial flows, and particularly for flows to developing countries. Such difficulties may be alleviated if regulations which could have far-reaching repercussions could be introduced gradually, and interpreted flexibly in the initial stages. This could apply, for instance, to movements in the direction of global capital ratios. Abrupt changes in the regulations imposed by some national authorities on their banks' activity in the international markets have occasionally had an appreciable effect on market conditions generally. It would be desirable to avoid such abrupt changes in the future.

(e) Relations between the banks and the Fund

31. Another complex set of issues surrounds the relationships between commercial banks, supervisory authorities and the International Monetary Fund when a country agrees an adjustment program with the Fund–and particularly when some rescheduling of debt is involved. If the Fund's resources are to provide a net addition to the total resources–private and official–available to a country in need, it is highly desirable that, when the Fund extends credit, private creditors should be willing to maintain their exposure or, at the least, that they should not withdraw an equivalent amount. Indeed, the Fund and the borrowing country will normally look for a further net inflow from private sources; one of the most valuable functions of the Fund is clearly its ability to negotiate conditions for access to its resources, and its role as a "catalyst" in attracting private flows is an important reason for the conditions on which it insists. The commercial banks recognize that they as well as the country concerned benefit greatly from the fact that an institution exists capable of performing functions that they cannot fulfill. They will also wish to avoid political allegations that they are being "bailed out". So the banks should be prepared to maintain some level of exposure that, as a minimum, provides the country with a net increase in the total external resources available to it. On the other hand, conditions attached by the Fund to its lending will need to be sufficiently stringent to encourage an adequate flow of credit from private sources (this subject is discussed further in paragraphs 39, 40 and 44).

The Role of the Fund

32. Given the need to achieve a proper balance between adjustment and financing, a crucial role devolves upon the International Monetary Fund. The manner in which it functions will be crucial to the stability of the system and will require the availability–and indeed the use–of resources

on an unprecedented scale. The necessity for the Fund to be able to provide large resources arises from two interrelated causes:

(a) Individual countries, small or large, may find themselves in intractable payments positions with an obvious need both for the adoption of adjustment policies and for finance to make the transition to a sustainable situation politically bearable. Only if the Fund can proffer finance on a substantial scale to a country in such circumstances, can it effectively encourage the adoption of constructive policy changes. It may be hoped that the Fund's assistance will unlock capital flows through the market; but reliance cannot be put on market flows alone, and the resources that the Fund can make available need to be large enough to give a country's adjustment program a fair start.

(b) The risks are not exclusively with the policies of individual countries. As outlined above (paras 24 to 26), in a world characterized by the presence of massive and violent shifts in the distribution of these imbalances, there exists a risk that important links in the "recycling" mechanism may break down, with possibly wider consequences. In such circumstances, the Fund must be ready to support the solidity of the system. The Fund must therefore be able to fulfill a contingency function which may be crucial and the magnitude of which is quite impossible to forecast.

33. The case for a larger role by the International Monetary Fund does not rest, therefore, on calculations of a "gap" between the likely scale of private flows and the "needs" of developing countries in general. If the system runs smoothly–thanks in part to the Fund's operations with individual countries–such a gap may never arise. But the Fund's operations with individual countries–in particular, if some of these are large countries–will involve very sizable amounts, in any event. The Fund could make its greatest contribution to the adjustment process and the solidity of the system by concentrating its assistance on countries engaging in major adjustment programs. In this manner, the Fund would avoid merely replacing lending to countries that have access to the markets.

(a) Financing growth in Fund resources

34. The resources that the Fund can use can essentially come from two sources, quotas and borrowing. The Fund's Interim Committee has stressed that the Fund should continue to place primary reliance on subscriptions under members' quotas as a source of financing the Fund's operations. The Study Group shares this position. Unfortunately, quota increases have not kept pace with the growth of members' international

transactions, and even less with the growth of payments imbalances. Even with the recent 50 per cent increase, aggregate quotas amount to only some 4 per cent of members' imports, as against 10 per cent in 1970 and even somewhat higher percentages in the 1960s. The Executive Board of the Fund is making an early start on the next (the Eighth) quinquennial review of quotas; but the results of that review, whatever they may turn out to be, are unlikely to become available much before the middle of this decade.

35. There is no question, therefore, that the Fund will have to take recourse to borrowing if it is to provide its members with assistance on a scale commensurate with the size of the problems they are likely to incur in present circumstances. In the 1970s, the Fund arranged twice to borrow from oil exporters and from some industrial surplus countries—about SDR 7 billion under its Oil Facility in 1974-75, and, more recently, about SDR 8 billion under the Supplementary Financing Facility. The money that was available to the Fund under the latter facility has already been committed, so that arrangements for new loans are clearly required. These may again be obtained from surplus countries, or the Fund might tap the capital market or use both sources. Borrowing from surplus countries would use an established technique and could be for very large amounts from a small number of official creditors; market borrowing could take the form either of credits from large commercial banks, or of public issues. Market borrowing raises a number of technical issues with which the Fund has not had to deal in the past. But it also has the special attraction that any arrangement that the Fund could conclude in the market would be purely commercial. Moreover, the establishment of a commercial market for Fund issued paper, in which surplus countries might acquire substantial amounts of such paper, would benefit official holders because it would provide enhanced liquidity for the claims held by them. At the time of going to press, the Fund was making plans to obtain lines of credit amounting in total to SDR 6 or 7 billion this year, and further amounts in 1982 and 1983. In our view, such borrowing, amounting in total to some $20 to $25 billions, may well be required over this three-year period.[1]

36. The Fund's financing activities are likely to lead to a considerable increase in the volume of SDR-denominated claims in the monetary system. The Fund's credits to its members are, in effect, denominated in SDRs, and the resources the Fund uses to extend such credits (i.e., the

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[1] As this publication was being passed for press, it was announced that the Saudi Arabian Monetary Agency has agreed in principle to lend SDR 8 billion to the Fund over the next two years. It was expected that the agreement would be finalized in May, 1981.

liabilities of the Fund that match its assets) are similarly expressed in SDRs. Insofar as the Fund uses contributed (quota) resources, this follows from the Fund's Articles of Agreement; insofar as it uses borrowed money, the SDR denomination is a standing practice of the Fund which safeguards it against running an exchange risk in its transactions. The consequence of these arrangements is that the large expansion of Fund credit which is likely to occur in the next few years will create a corresponding increase in SDR-denominated assets held by countries with creditor positions in the Fund and by lenders to the Fund. To acquire these SDR positions, countries will generally have provided currencies, most likely US dollars, to the Fund. It is clear, therefore, that the Fund's credit operations will—as a by-product—have certain effects that have much in common with those envisaged for a "Substitution Account."[1] Countries with ample reserves will be able to exchange a portion of their dollars for SDR-denominated claims on the Fund. These claims may resemble the SDR claims envisaged for the substitution account in a number of other respects: e.g. they may be transferable, and earn a floating interest rate linked to the market interest rates on the five component currencies in the SDR basket (US dollar, DM, Pound sterling, French franc, and Japanese yen). But although the Fund's credit activities are likely to be large, and will thus perform some of the task of off-market diversification for which the plan for a substitution account had been designed, they cannot be expected to reach the scale of SDR 50 billion over a five-year period envisaged for that account.

(b) The cost of borrowing from the Fund

37. With respect to the cost of borrowing from the Fund, resources made available from quota subscriptions reflect the cooperative character of the Fund. The creditor countries whose currencies are used receive less than the full market rate on their contributions, and this permits the Fund to lend these resources at less than market rates. For borrowed resources, the Fund will have to pay approximately market rates. Even though such rates will no doubt reflect the superior credit standing of the Fund, the Fund has to charge considerably more when on-lending borrowed money than when it lends its own resources. For countries whose alternative source of finance would be the Euro-markets, even borrowed Fund money would still come somewhat cheaper than market resources. But for the low-income developing countries, borrowed money passed on by the Fund will clearly become too expensive.

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[1] For a discussion of the concept of a substitution account, cf. an earlier policy paper of the Group of Thirty, "Towards a Less Unstable International Monetary System" (New York, 1980).

38. In part, the response to this problem will have to lie in the provision of grants and low-interest loans to these countries to assist them in staying on their development paths. But the Fund itself can provide relief to the extent that it has resources to subsidize the interest rates that it has to charge. To this end, the Fund established, in late 1980, a subsidy account to reduce for low income countries the effective interest cost of resources borrowed by the Fund under its supplementary financing facility. It is hoped that this account will attain SDR 1,000 million. Part of its resources are to come from voluntary contributions by countries that are in a position to give foreign aid in this form. Fortunately, the Fund has a further source of money on which to draw for the subsidies: the profits on the sale of part of its gold over the past four years that were lent out as 5 to 10 year low-interest loans to low-income developing countries (an amount of close to $4 billion) and which will soon begin to generate a flow of repayments. Of these repayments, SDR 750 million will flow into the subsidy account. The Fund has, however, no arrangements to reduce the cost of money borrowed under its more recent borrowing arrangements. Moreover, the Fund appears to have concluded against further gold sales in the market, thus maintaining its still very substantial gold holdings (over 100 million ounces, worth $50 billion at a gold price of $500 per ounce) as part of the asset structure in its balance sheet, to bolster its ability to borrow.

(c) Conditions for access to Fund resources

39. The ability of the Fund to perform the functions that are called for in present circumstances does not only depend on its ability to attract sufficient resources. While the modalities of further quota increases for the Fund, and especially of its borrowing on a much larger scale than it has done so far, naturally raise many problems, there can be little doubt that these problems can be overcome and that an institution with the international backing and the assets that the Fund commands should be able to acquire the resources necessary for its task. The more difficult issue before the Fund is whether it will be able to submit its lending activities to conditions that will meet the twin tests for its success: that countries in need of adjustment action will come to the Fund for its assistance, and that the nature, the intensity, and the speed of adjustment on which the Fund insists will be sufficient to restore, over time, the economic and financial viability of the countries that draw its resources. The Fund is, in this respect, faced with a clear dilemma: if its conditions are too rigorous, countries may have recourse to highly undesirable restrictive policies, rather than come to the Fund; if they are too loose, the Fund resources may be poured into situations that fail to be remedied, countries' credit-worthiness will not be restored, and the Fund's credit may, in fact, prove to be frozen.

This dilemma is commented upon further below (paras 44-45).

40. It is clear from what was just said that conditionality is an indispensable element in the Fund's operations. It is no service to a country–or any other borrower–to allow or encourage an increase in the burden of indebtedness beyond its capacity to service that debt. It is in a country's own interests–though not necessarily in that of the government of the day–to restore its economic and financial viability as rapidly as possible. It is also in its own interests to maintain its access to other sources of finance, and these may be forthcoming only if the country negotiates a program of adjustment with the IMF. From differing perspectives, both the markets and the Fund now provide a cushion against external shocks. In the words the Fund used of its own operations many years ago, both the markets and the Fund provide "time, but not time to waste".

(d) Closer association between the Fund and its members

41. In recent years, with the much wider development of credit through the international banking system, there has been an increasing tendency that only members in the most severe difficulties would use the Fund, which has thus tended to become a lender of last resort. True, there have always been a number of commendable exceptions–countries that have maintained standby arrangements as a normal part of their financial management. But if the Fund is to continue to perform its functions in an efficient way, it remains desirable that countries come to it before their problems have become virtually intractable; and there have been some

New Loan Commitments and Other Use of Fund Resources
(billion SDRs)

Calendar Year	**1973**	**1974**	**1975**	**1976**	**1977**	**1978**	**1979**	**1980**
1. New Loan commitments under stand-by and extended arrangements in period	0.4	1.4	1.2	0.9	5.2	1.9	2.2	7.2
Industrial countries	—	*1.0*	*0.8*	—	*3.8*	*0.1*	—	—
Developing countries	*0.4*	*0.4*	*0.4*	*0.9*	*1.4*	*1.8*	*2.2*	*7.2*
2. Other uses[1]	0.2	1.9	3.6	4.6	0.3	0.7	0.7	1.0
Industrial countries	—	*0.8*	*1.5*	*1.7*	—	*0.1*	—	—
Developing countries	*0.2*	*1.1*	*2.1*	*2.9*	*0.3*	*0.6*	*0.7*	*1.0*
3. Trust Fund loans disbursed (developing countries only)	—	—	—	—	0.2	0.7	0.5	1.3
Total (1 + 2 + 3)	0.6	3.3	4.8	5.5	5.7	3.3	3.4	9.5

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[1] Mostly drawings under the compensatory financing and oil facilities.

indications in recent months that a change in this direction is under way. Indeed, greater use of Fund resources has already been reflected in the statistics of new loan commitments and other use of Fund resources. As the accompanying table shows, there has been a very sharp increase in new loan commitments under programs of one to three years, and if these are combined with balance-of-payments assistance provided by the Fund outside such programs, a total of SDR 9.5 billion was committed or used in 1980, compared with SDR 3.4 billion in 1979.

42. We believe that further progress in encouraging countries to come to the Fund at an early stage in their payments difficulties could be promoted. In particular, the Fund could develop its Article IV Consultations to generate a continuous understanding with each member on the adequacy of its policies. Such an understanding could serve to facilitate, and thereby to compress in time, the negotiations that would be required to reach agreement on a standby arrangement in case of need. One step that could be considered in this connection would be to give publicity to the results of the annual consultations whenever the country concerned wanted this. The Fund could, in those circumstances, release its views on the country's policies, which might convey a broad approval of these policies, but also specify areas in which the Fund had reservations. The mentioning of such reservations would, at the same time, point up publicly areas in which changes would probably be necessary if the country wanted to conclude a standby arrangement with the Fund and might strengthen the hand of the government to bring about such changes. Public knowledge about the extent to which the Fund was prepared to endorse a country's policies would certainly assist the banks in their appraisal of the country. However, it should also be recognized that publication could raise political difficulties for the government of the country concerned and that governments' apprehension of this might even lead them in some circumstances to withhold confidential information that they now give to the Fund.

43. A closer association between the Fund and its members through more intensive use of the consultations procedures would reduce the risk to which the international financing mechanism is exposed, and it would also be likely to improve the adjustment process, even if such association did not lead to a very large volume of Fund transactions. While the commercial banks have performed an outstanding recycling job, there are certain tasks in the international adjustment process that are beyond their reach but which the Fund can perform, in addition to its financing function. The Fund is in a position to monitor the performance of members'

economies. In its consultative role in the context of Article IV, its periodic inquiries into the policies of member countries are likely to act as a wholesome constraint even where no specific limits (e.g., on credit expansion) are agreed with a country. Moreover, the Fund's analysis of global economic interrelations is essential both as a background for members' policies and for its own effective operation, and its ability to perform these functions is critically dependent on its thorough understanding of the conditions and the policies of its member countries.

44. Where countries do require finance, there is a strong case for arguing that the Fund should stand ready to provide conditional assistance on a larger scale and over a longer period than in the past. To fulfill its function of safeguarding the stability of the system, and maintaining the progress made in the past generation towards an open world currency and trading system, the Fund should be prepared to take greater risks than private lenders can justifiably assume. Assistance on a larger scale (in relation to quotas) than in the past is needed because of the size of current imbalances and the risk of a breakdown in the recycling mechanism; over a longer period, because (as already noted) the kind of adjustment called for by the adverse change in countries' external circumstances will often require increasing investment, and effecting "structural" changes, which bear fruit only over an extended period.

45. The Fund has indeed modified its practices along these lines. It has adopted a guideline for the amount of assistance it is willing to grant of 450 per cent of the (recently-increased) quotas over a three-year period, with annual limits of 150 per cent of quotas and an upper limit on credit in the credit-tranches of 600 per cent of quotas, a sixfold increase over the 100 percent of quota limit over any period of time normally applied until a few years ago; it has shifted its emphasis from one-year to three-year credit arrangements; and it has lengthened the maximum period of repayment under the "Extended Fund Facility" from 8 to 10 years. All these changes have the effect of mitigating the dilemma (referred to in paragraph 39) that the Fund faced. First, if a country can obtain assistance from the Fund on a much larger scale, this improves its cost-benefit trade-off for using the Fund's resources. And second, increased financing over a longer period of time makes it possible for the country to reduce the extent of the adjustment necessary in the first year of an arrangement with the Fund while, at the same time, committing itself to a course of action that can be expected to achieve the needed adjustment over time.

46. Because of the multi-faceted nature of the adjustment process that many countries face in present circumstances (see paragraph 7 above), the Fund's approach in the field of adjustment will also have to be broader than that on which it placed its main emphasis in the past, viz., the correction of inadequate financial policies. Action in this field will still be needed in the cases where such policies are a major cause of a country's payments difficulties. But other policy changes may be needed in almost all countries that come to the Fund for assistance in order to adjust their economies to the three fundamental changes in the economic environment: slower growth in the industrial world, the sharp increase in energy prices and the move to positive real interest rates. These latter policy changes lie generally in the area of supply (of new commodities for export, of alternative sources of energy, etc.). Hence, to assure itself about the general creditworthiness of the countries it assists, the Fund will need to concern itself with supply policies, not in substitution for, but in addition to, its concern with demand policies. It is obvious that in dealing with policies on the supply side, the Fund approaches the area of competence of the World Bank, just as the World Bank approaches the Fund's field of activity by extending its lending activities to "structural adjustment loans" (see paras 55-57 below). These convergent changes in the activities of the two institutions call for close collaboration between them, and there are welcome signs of developments in this direction.

(e) Help for the poorest countries

47. In the previous paragraphs, much attention has been focused on the role of the Fund as a backstop or a lubricant of the framework of a recycling process consisting largely of flows of private capital. This is indeed the largest component of the flow of capital to LDCs. But these flows are directed to the more fortunate of the developing countries, those that have established access to the international money and capital markets. It is equally urgent to devote attention to the difficult payments problems of the poorest developing countries, which—generally speaking—are not in a position to have recourse to private credit when faced with payment difficulties. These countries do not provide the examples of crises of overborrowing, followed by massive rescue actions, of the last decade; they cannot borrow what they need, let alone beyond their needs.

48. For these silently suffering countries, the IMF is the main source of balance-of-payments credits, and the willingness and ability of the Fund to assist these countries on an adequate scale, and on terms they can afford, is one of the keys to smooth progress of their development. Equal-

ly–perhaps even more–essential for these countries, which cannot rely on the world's financial markets for their development capital, is the provision of an adequate and increasing flow of concessional aid. The problems of these countries are considered further in paras 75 to 78 (see also paragraph 38).

(f) SDR allocations

49. There is one further respect in which the Fund contributes in a modest way to the alleviation of the debt problems of the developing countries. These countries, like other countries, feel the need for a trend increase in the level of reserves that they maintain broadly in line with the secular rise in the value of their international transactions. The acquisition of these reserve increases through the market mechanism involves, directly or indirectly, an increase in foreign borrowing and hence-even if the additional borrowing can be arranged without difficulty–the use of some portion of a country's access to credit, which is by no means unlimited. To the extent that the Fund meets the needs of its members for increases in reserves through the annual allocation of SDRs, countries can preserve their access to credit and, incidentally, also acquire reserves at a somewhat lower interest cost. In its decisions on SDR allocations the Fund must obviously take account of any inflationary risk to which it would expose the world economy if it were to set the annual figure too high. Amounts in the order of magnitude of those allocated in 1979 to 1981, SDR 4 billion per year of which about SDR 1 billion went to the non-oil developing countries, could hardly be faulted on that ground.

The role of the World Bank

50. The major contribution of the World Bank in current circumstances is to help developing countries sustain the momentum of their economic development, so far as possible, despite the adverse change in their external environment. It makes this contribution by way of both project and non-project lending and through its non-financial, advisory role. One of its main strengths is its ability to draw upon an extensive operational experience and to associate advice with a willingness to provide substantial finance. However, its capacity to maximize its potential contribution is a present limited by a growing shortage of resources and by policy guidelines adopted by the Executive Board.

(a) Energy-related investments

51. The importance of the World Bank's project financing in helping to sustain investment is perhaps clearest in energy-related investments.

The price of oil in real terms is now more than five times what it was in 1972. This shift in relative prices applies to all forms of energy and has thus altered investment priorities in a wide range of sectors; these include not only the commercial exploitation of primary energy resources, but also the production and use of traditional fuels (notably wood), as well as transport systems and the use of energy in existing industrial plants.

52. The very large energy investments which lie ahead in the developing countries have led to the proposal that the World Bank should further expand lending plans in this sector. A World Bank report published in August 1980 described in some detail an expanded lending program totaling $25 billion over a five-year period, a near doubling of its current lending plans for energy.

53. An expanded program of energy-related financing would contribute directly to the reduction of world energy imbalances and thus strike at a root cause of the recycling problem. It is estimated that additional production and energy savings associated with an expanded investment program over the next five years could save the developing countries something on the order of three million barrels of oil-equivalent a day once these projects are fully on stream. Indeed, such an effort may be essential to the oil-importing countries' hopes for continued economic growth, since the balance-of-payments savings attributable to three million barrels a day of oil equivalent could reach $40 billion a year (in 1980 prices) by 1990.

54. As a vehicle for financing expanded energy operations the World Bank has been investigating the establishment of an energy affiliate. The affiliate would be market-based in the sense that only a minor part of its resources would represent budgetary outlays by governments. Most of the resources would be borrowed either from the various capital markets or directly from governments. We believe that direct borrowing from surplus countries would be a constructive contribution to the recycling process and should be pursued. It would also be desirable for the surplus countries to have a major stake in the equity of an affiliate. In fact, this may be an important incentive to these countries to agree to substantial direct loans to the affiliate. Despite continuing difficulties in establishing an affiliate, we believe that the need to foster the development of energy resources in developing countries is sufficiently urgent to justify the Bank giving a high priority to its plans in this area, possibly by opening a new "energy window". Assistance provided by the Bank under such a program would be complementary to investment by the private sector and governments.

(b) Balance-of-payments adjustment financing

55. While project investments in energy have a direct and immediate link to the recycling problem, the balance-of-payments pressures caused by the shift in most developing countries' terms of trade and by the slower growth in their traditional export markets have greatly increased the external financing requirements needed to support domestic economic growth in these countries. This by itself would seem to call for some increase in the intermediation role played by the World Bank and the regional development banks. However, increases in planned project lending will not add significantly to capital inflows over the next year or two. The volume of external resources to be provided by the World Bank in this form over this period is already largely determined.

56. To help the developing countries cope with their immediate balance-of-payments deficits in a way which minimizes the penalties to their longer-run development and growth objectives, the World Bank recently decided to supplement its traditional project lending with so-called *structural adjustment loans*. These loans support programs designed to increase the efficiency of resource use and to re-orient production and trade patterns so as to achieve a viable balance-of-payments position within a few years. Commitments of this kind might amount to $800 million in the current fiscal year (ending June 1981) and could rise substantially in later years.

57. These amounts are small in relation to the financing problems of the developing countries. Nevertheless, to the extent that structural adjustment loans are associated with changes in domestic policies which promise greater efficiency in domestic resource use, they can form the basis for expanded capital flows from private sources.

(c) Collaboration with the Fund

58. The World Bank's role in lending for structural adjustment is clearly complementary to that of the IMF. Indeed, the two institutions have typically collaborated quite closely in cases where the imbalance needs to be corrected over an extended period through a combination of fiscal and monetary restraint with specific measures to encourage reallocation of resources into exporting or efficient import-substituting activities. The Bank's ability to commit somewhat longer-term funds and to advise on sector-specific resource allocation issues complements the IMF's established role and its ability to mobilize short and medium-term financing.

59. The established collaboration between the two institutions is likely to ensure that structural adjustment loans given by the Bank will fit into the

pattern of financial adjustment to which the Fund pays primary attention and that Fund assistance under the Extended Fund Facility will pay adequate attention to required changes on the supply side on which the primary experience lies with the Bank. No doubt the amounts made available by the two institutions will be coordinated. There is little risk therefore that the Bank and the Fund, in implementing their rather similar facilities, will either duplicate each other's efforts or operate at cross purposes. There does remain a question, however, whether–now that each institution has become fully convinced of the need for the observation of both supply and demand conditions in almost all cases–it remains useful for both to provide resources for what has in effect become a single need of its members.

60. Two criteria are relevant in this connection. The first relates to the aspects of the economy that require structural adjustment. These involve in virtually all cases the country's major financial policies, thus calling for direct involvement of the Fund through an extended arrangement. But in some cases major adjustment in a particular economic sector (eg agriculture) is also needed, which could be assisted by a structural adjustment loan. A second criterion relates to the total availability of funds. It is clear that both the Bank and IDA are encountering extreme difficulties in adding to their flow of resources. This inevitably limits the extent to which the Bank and IDA can give without contracting their other lending activities. On the assumption that the Fund will be successful in marshalling large borrowed resources, that institution will be subject to less financial constraint in providing resources for balance-of-payments adjustment. If these two criteria are followed the bulk of such financing is likely to be performed by the Fund, with financing by the Bank and IDA concentrated on restructuring of key sectors. (There is a separate issue on the extent to which the Bank's and IDA's regular lending should take place as project loans or as program or sector loans; the discussion in this paragraph is not addressed to this issue).

(d) Resource constraints and policy guidelines

61. As noted above, the ability of the World Bank and the regional development banks to expand either their project or their non-project lending in response to the increased financing requirements of the developing countries is limited partly by resource constraints, but also partly by reversible policy decisions.

62. The resource constraints are most acute on the concessional side: that is, the availability of IDA-type resources. As has often been noted, the poorest developing countries are the ones least able to respond to

deterioration in their balance of payments by reducing growth rates or deferring development investments. They are also the ones least likely to obtain financing from private sources: recycling has little meaning to these countries except to the extent that enlarged funds can be obtained from official sources. Essentially, these are the only sources available to them to help them effect a rational and orderly adjustment.

63. IDA is the largest single source of concessional finance for the poorest countries. Yet IDA's new lending operations were brought to a halt in April 1981 because the United States had not ratified the latest replenishment agreement. True, continuing disbursements under prior credits mean that the immediate impact on the poorest countries' balance-of-payments situation is not yet large. But a penalty is already being paid in terms of delays in implementation of new development projects. These penalties will mount rapidly if IDA commitment authority is not restored quickly. The key requirement is that the Congress should promptly ratify the commitment made by the previous Administration and re-affirmed by President Reagan's Administration.

64. The IBRD itself is also subject to resource constraints, partly in terms of its ability to borrow, but more importantly in terms of the availability of share capital subscribed by member governments. This share capital, which is mostly in the form of guarantees of IBRD borrowings, was recently increased by $40 billion. Provided that governments subscribe to this increase (beginning in September 1981), the IBRD will have enough capital to support a substantially higher volume of lending than is currently planned. What stands in the way of exploiting that capacity is not a legal or financial constraint, but rather a policy decision setting IBRD growth at an annual increase of 5 per cent a year in real terms. Were this policy decision to be modified in the light of the IBRD's potential contribution to easing the recycling process, part of the increased lending would go into non-project or sector lending—and thus contribute to the financing of existing payments deficits—but a larger part would go to support investment projects, and thus reduce the extent to which adjustment forces countries' development plans to be held back. We believe that in the present exceptionally difficult circumstances the 5 per cent guideline should be revised to permit expanded lending to take place, particularly in the energy sector.

65. Another factor affecting the Bank's lending capacity is its so-called "gearing ratio". This ratio, which is part of the Bank's legal charter, limits outstanding loans to the total of its capital and reserves. Such a 1 to 1 ratio is very conservative. We recommend that this limit be reviewed.

While such a change needs to be carefully managed so as not to alarm existing and potential creditors of the Bank, we have no doubt that a substantially higher ratio—say, 2 or 3 to 1—would still leave creditors very well protected.

(e) Co-financing

66. Apart from its direct assistance to developing countries' investment strategies, the World Bank also stimulates other private and official capital flows, notably through cofinancing operations. In these operations, funds from the World Bank are "associated" with funds provided by private sources (these private lenders have separate agreements with the borrowers). Including all types of "cofinancing" arrangements, such operations increased from $1.5 billion in fiscal year 1974 to $6.5 billion in fiscal year 1980; cofinancing arrangements with private lenders rose from $85 million to $1.8 billion over the same period. Some commercial bankers have for several years been seeking to persuade the World Bank to do more in this area, particularly by means of strengthening cross-default clauses in co-financing. (At present neither the World Bank nor co-lenders are required to take any further action following a default). To make such provisions significantly more attractive to commercial banks, the present arrangements would need to be changed so that default on a private credit extended under a cofinancing arrangement required the World Bank to commit itself to take further action, such as halting new operations in the country concerned. However, this would probably be strongly resisted by borrowers, thus possibly reducing the volume of co-financing, and would tend to deprive the system of an element of flexibility. Given these realities, the further growth in traditional co-financing is unlikely to be dramatic.

Other Proposals for Assisting Capital Flows

67. A wide variety of other suggestions have been made in recent months for assisting the flow of capital to developing countries. The study group has not been able to examine all of these. Of those it has studied, however, few satisfy the criteria that the proposed scheme should offer prospects of adding significantly to the sustainable net flow of resources to the non-oil developing world, should not jeopardize their longer-term growth prospects and should not interfere with needed adjustment.

68. Many proposals involve the provision of further (full or partial) *guarantees for private loans or credits*. Yet in many respects the system

can be said to be already overloaded with guarantees–guarantees tied to export credits, or other guarantees by governments or official agencies in creditor and debtor countries. In so far as the IMF and World Bank are concerned, the IMF is not empowered to offer guarantees; and guarantees by the World Bank suffer from the objection that the Bank might as well make the loan itself; the same capital backing is needed for Bank guarantees as for its direct loans.

69. Provision of further guarantees (by newly-established official agencies or affiliates or by other organizations) often suffer from other drawbacks. They can easily have the effect of undermining the responsibility of private lenders for appraising creditworthiness, an essential check in the system, and of borrowers, in ensuring that the funds are put to good use. To the extent that they lessen the need for discrimination by lenders they would tend to encourage the overprovision of finance. Ironically, calls for further guarantees are often made by observers who also claim to be very worried about the "over-indebtedness of developing countries". But it is no service to these countries to encourage them to increase their indebtedness to levels that exceed their probable capacity to service the debts. Indeed, one of the reasons why countries have often come to the Fund at a very late stage in their payments difficulties may be that private finance–much of it "guaranteed"–has in some cases been too readily available. The provision of more guarantees on bank lending might only further undermine the Fund's authority. In addition, borrowers themselves may view guarantees as posing some risk to the continued growth of unguaranteed lending.

70. Other proposals are directed towards upholding confidence in the international banking system in times of stress; various arrangements to provide supplementary liquidity to the system at such times might be devised. One suggestion is that a "*safety net*" be established among the major international banks to assure access to liquidity when the inter-bank market is under stress. We recognize the attractions of such proposals but, on balance, we do not think they are likely to be effective in practice. Proposals to structure a safety net on the basis of swap arrangements between commercial banks (drawn along the lines of similar facilities between central banks) suffer from the critical weakness that their effectiveness depends on inter-bank confidence, which is precisely what is lacking in crisis situations. In such situations, only the central bank has the competence to act as 'lender of last resort' and the authority to require acceptance by all parties of its terms.

71. The most logical channel for recycling takes the form of *direct loans and aid from OPEC countries* to non-oil LDCs. The OPEC countries already provide an estimated one-quarter of all aid to the developing world, and two of them, Saudi Arabia and Kuwait, rank among the six largest bilateral donors in absolute terms. The aid is also being distributed more widely than in the early 1970s, as shown by the rapid growth in the number of non-Arab participants to about 65 in 1978; according to DAC figures, of the total official flow of resources to all non-OPEC countries from OPEC countries and Arab/OPEC multilateral aid institutions, nearly 40 percent went to non-Arab nations. Between 1975 and 1980, OPEC's official development assistance totalled between $5 and $6 billion a year, according to OECD figures. In this connection it is encouraging that three oil-exporting countries—Mexico, Venezuela and Kuwait—have recently announced the provision of substantial further low-interest resources to non-oil LDCs. It is to be hoped that this example will be followed by others, so that the risks of lending to non-oil LDC's will be shared more widely by OPEC countries.

72. Various suggestions have also been aimed at increasing the *flow of direct investment* to non-oil LDCs. Support for such flows is provided by *investment guarantee schemes* established by DAC member countries, which offer cover against "political" or "non-commercial" risks, by the IFC, and also by government-sponsored investment corporations established by a number of industrial countries. With respect to these and other proposals the OECD has commented ("Investment in Developing Countries" page 10) that "the possibilities for action on the part of the governments of capital-exporting countries to stimulate the flow of private capital to developing countries are rather limited. However elaborate the incentive measures introduced by donor countries, the major responsibility for the improvement of the investment climate remains with the host countries."

73. One interesting suggestion has recently been made for a mixed official-private guarantee fund to insure the risks of direct investment in developing countries.[1] Shareholders in this fund would be governments and central banks of developed and developing countries as well as commercial banks. The fund would guarantee direct investment projects provided they were found to be commercially viable and fitted into the development priorities of the country in which the investment would take

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[1] Proposal for an "International Credit Guarantee" made by Dr. H. J. Witteveen at *Financial Times* Conference, Sri Lanka, September, 1980.

place but that country would not have to provide a guarantee. The insurance offered by the fund would cover part of the country risks and perhaps also part of the project risks. This proposal has been submitted for consideration to the "Task Force on Non-Concessional Flows" of the Bank/Fund Development Committee.

74. On another matter, we believe that consideration shold be given to means of encouraging greater participation in the international financial markets by *non-bank financial intermediaries*, notably by insurance companies, pension funds and other institutions in the industrialized countries. Such institutions usually invest their funds in government paper, real estate or in domestic stock markets, and their investment policy is often subject to statutory or other official constraints. In addition, developing country access to the US capital market is limited by the New York State restriction that US insurance companies may hold no more than 1 per cent of their assets in foreign securities. The US Treasury has informed the state authorities that it supports the liberalization of the present overall ceiling on foreign security holdings from 1 percent to 2 percent of each company's total assets. While insurance companies may be reluctant to build up their holdings of securities issued by LDC borrowers rapidly, we believe that a further liberalization of the US and other capital markets could open new sources of funds for international institutions, such as the World Bank and even the IMF, if it were to borrow in the markets–sources that would be complementary to existing channels.

The Problems of the Poorest

75. The general development problems of the poorest countries are outside the terms of reference of our enquiry. However, the surge in the real price of energy and the slowdown of economic growth in the industrial countries have occasioned a further significant deterioration in the life chances of the hundreds of millions of people living below the poverty line. What can be done to ease the balance-of-payments problems of the poorest countries, for many of which the term "recycling" is irrelevant because they have no prospect of becoming creditworthy in the markets?

76. We have already outlined the roles that the official multilateral agencies can play (that of the IMF in paras 38 and 47-48 and that of the IDA in paras 61-63). We have also made clear that we think that OPEC

countries should further increase the flow of concessional funds both within and more especially outside the Arab world. Plainly, survival for many of the people living in such countries will depend on a substantial increase in aid, the prospects for which are not good.

77. In view of the bleak prospects for low-income countries, a new approach is needed to the payments problems of these countries. In recent years the ideological gulf between the rich and poor has widened, and UN special sessions as well as debates at the General Assembly have witnessed increasingly bitter criticisms of the existing monetary system in general, and of the roles of international institutions in particular. At the same time, while the prospects for the poorest countries (which carry many votes in such assemblies) have deteriorated, the proportion of total aid flows going to them has not increased substantially. The further rise in the price of oil, of fertilizer and thus of food has been another bitter blow.

78. In these circumstances we believe that the international community should respond by establishing a program under which international institutions (notably IDA and the regional developments banks) would enable countries to finance payments deficits at highly concessional rates of interest (such as ¾ of one percent). The level for each country's deficit could be set, in advance, in the context of an agreed development plan, revised periodically. The additional funds required might not need to be very large in relation to existing aid flows, since they would supplement flows that each country receives from its respective donors. Economically, this might give the governments of these countries better possibilities for planning their economic development, by being assured in advance of being able to finance a given deficit. Politically, such an initiative might help to defuse the ominous trend towards an increase in confrontation between developed and developing countries.

Conclusions and Recommendations

79. Massive shifts in payments imbalances caused by the further escalation of the price of oil and slower growth in the industrialized countries are imposing unprecedented strains on all non-oil developing countries and on the international financial system. The broad conclusion of our study is that these strains are manageable, but they have to be managed and not just left to chance. In this respect the current degree of concern with the functioning of the system shown by governments, central bankers, the international institutions and commercial bankers is itself

healthy and welcome. This concern needs to be focused, however, and translated into action, or contingency planning, to support indentifiable weak points in the system, rather than left floating as an undifferentiated cloud of anxiety. For unreasoned anxiety could itself cause any problems that arise to snowball quite unnecessarily: to a greater extent than ever before, the viability of the system rests on the maintenance of an adequate degree of confidence.

80. Throughout this study we have been concerned to identify such weak spots, and to propose what we believe to be practicable responses. Many other proposals have been made from time to time, but many of these are in our judgment not practicable or not advisable (such as proposals involving a further indiscriminate extension of guarantees on bank loans). Various sections of this study have offered suggestions directed to governments, central banks and banking supervisors, commercial bankers and international institutions. The following is an attempt to summarize the main points made.

Governments

81. (a) In their own interests, countries should adjust as rapidly as is economically and politically feasible to the adverse change in their external circumstance brought about by the further rise in the oil price and slower growth in their main export markets. Adjustment cannot be avoided indefinitely by recourse to financing, even if much larger flows of official financing were to be available.

(b) The nature of the change in external circumstances will call in most cases for adjustments both in the area of demand management and in other policies affecting conditions of supply. The principal objectives in the latter case should be to raise levels of domestic investment generally (i.e. to take further the progress made by many developing countries in the 1970s), to develop indigenous sources of energy and hold down energy use. Many countries will have to accept temporary or longer-lasting restraints on demand.

(c) All countries should resolutely resist pressures, which could mount rapidly, to adopt protectionist measures. By giving the wrong signals at the wrong time, the adoption of such measures would jeopardize the entire structure of the world's open trading and currency arrangements constructed with such difficulty over the years since World War II.

(d) Governments and central banks in market centers should do whatever they can to facilitate access by LDCs to their capital and money markets. Existing regulatory or informal constraints in such areas should be relaxed.

Finance through the market

82. (a) We believe that the international banking system will have the capacity to intermediate the very large sums required, providing confidence is maintained.

(b) Although there has not yet been been a single case of a failure of, or even market concern with, a bank due to its exposure to LDCs, there are default risks in international lending; and in our judgment, these risks are increasing.

(c) Adequate standards of bank supervision are essential to the health of the system and thus to a continuing flow of capital to the developing countries. Supervision should lead to the establishment of widely-agreed prudential guidelines; it should involve exchanges of information between bank supervisors; and it should also provide for cooperative procedures to defuse a crisis. Beyond these areas of agreement, discussion revealed a range of opinion. Another study group of the Group of Thirty is examining this and other aspects of banking supervision and risk.

(d) Abrupt changes in the regulations imposed by some national authorities have occasionally had an appreciable effect on market conditions. The authorities in the leading market centers should bear in mind the consequences for the flow of funds through the markets of new regulations and approaches to supervision.

(e) When the IMF extends credit to a country in the context of an agreed adjustment program, creditor banks should preferably maintain their lending, or at least ensure that the IMF's funds provide a net addition to the total resources available to the country.

(f) Reliance cannot be placed wholly on market finance for two main reasons. First, individual countries may find themselves in intractable payments positions with an obvious need both for the adoption of adjustment policies and for finance to make the transition to a sustainable situation politically bearable. Secondly, there exists a risk that important links in the "recycling" mechanism may break down, with possibly wider consequences.

The role of the IMF

83. (a) Thus the manner in which the Fund fulfills its functions will be crucial to the stability of the system and will require the availability and use of resources on an unprecedented scale. These are necessary both to allow it effectively to encourage the adoption of constructive policies by a country in payments difficulties, and to support the solidity of the system as a whole. In our view, the Fund may well require some $20-$25 billion in borrowed funds over the next three years.

(b) The Fund's conditions for its lending must meet two tests for its success: first, that countries in need of adjustment will come to the Fund for its assistance, and secondly that the nature, the intensity, and the speed of the adjustment on which the Fund insists will be sufficient to restore, over time, the economic and financial viability of the countries that draw its resources.

(c) To encourage closer collaboration between the Fund and its members, consultations with members under Article IV could be developed further, and there might be advantages in some cases in publishing the results. A closer association between the Fund and its members would reduce the risk to which the international financing mechanism is exposed, and it would also be likely to improve the adjustment process, even if such association did not lead to a very large volume of Fund transactions.

(d) Where countries require finance, the Fund needs to stand ready to provide conditional assistance on a larger scale and over a longer period than in the past. Indeed, the Fund has already modified its practices along these lines.

(e) The Fund, like its member countries, will have to be more concerned than in the past with supply policies, not in substitution for, but in addition to, its concern with demand policies. This calls for close collaboration between the Fund and the World Bank.

(f) Another way in which the Fund contributes in a modest way to the alleviation of the debt problems of developing countries is through its annual allocations of SDRs. To the extent that these allocations meet the needs of members for increases in reserves, countries can preserve their access to credit and also acquire reserves at somewhat lower interest cost.

The role of the World Bank

84. (a) The World Bank's main contribution is to help sustain countries' development despite the adverse change in their external circum-

stances. One of the ways in which it does this is by its established programs of project and sector loans. It can also offer some assistance through its growing non-financial, advisory role. A third is through its so-called "structural adjustment" loans to help meet countries' immediate balance-of-payments difficulties. However, at a time when both the World Bank and IDA are encountering extreme difficulties in adding to their flow of resources, the bulk of balance-of-payments adjustment financing is likely to be performed by the Fund.

(b) In the field of energy, the IBRD has outlined an expanded program totalling $25 billion over a five-year period. One means being considered to mobilize finance for this program is the establishment of a new energy facility. We recognize the difficulties of establishing a separate affiliate. However, the Bank should continue to place a high priority on fostering energy resources in developing countries. Irrespective of the specific institutional mechanism that might be decided on, some way should be found to finance the program.

(c) The failure to ratify the latest replenishment of IDA resources has brought its new lending authority to a halt. Since IDA is the largest single source of concessional aid flows for the world's poorest countries, it is vital that the replenishment agreement negotiated a year ago be implemented promptly and in full. The key requirement is for the US Congress to deliver on the commitment made by the previous US Administration and reaffirmed by President Reagan's Administration.

(d) We believe that in the current exceptionally difficult circumstances the policy guideline limiting the growth of World Bank lending to 5 per cent a year in real terms should be relaxed.

(e) The study group supports the proposal that the ratio of the outstanding borrowings to capitalization should be increased (for instance, from one to two times its capital base).

The problems of the poorest

85. A new approach is needed to the payments problems of the poorest countries. In view of the bleak prospects for these countries, we believe that the international community should institute a new program under which international instututions (notably IDA and the regional development banks) would enable countries to finance agreed payments deficits at highly concessional interest rates (such as ¾ of one percent). The level for each country's deficit could be set, in advance, in the context of an agreed development plan. The additional funds required might not need

to be very large in relation to existing aid flows. Such a program would give the governments of the poorest countries better possibilities for planning their economic development and might help to defuse the ominous trend towards "confrontation" between developed and developing countries.

Other Proposals

86. The study group considered a number of other proposals for assisting the flow of capital to developing countries. However, few satisfied the criteria that the proposed scheme should offer prospects of adding significantly to the sustainable net flow of resources to the non-oil developing world, should not jeopardize their longer-term growth and should not interfere with needed adjustment.

Officers of the Group

H. Johannes Witteveen	Chairman
Robert Pringle	Executive Director
Geoffrey Bell	Executive Secretary
Robert Solomon	Treasurer

Two World Trade Center
Suite 9630
New York, New York 10048
Tel: (212) 775-9160

Group of Thirty

The Group of Thirty was established in December 1978, in order to explore the basic problems in the functioning of the international economic system. It meets twice a year, for two to three days at a time. Between these meetings, study groups and researchers gather material to serve as the basis for the Group's discussions.

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Group of Thirty

The Outlook for International Bank Lending

A survey of opinion among
leading international bankers

Compiled and edited by

M.S. MENDELSOHN

for

The study group on "Capital Movements
and the Growth of International Indebtedness"
of the Group of Thirty

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The Outlook for International Bank Lending

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The Outlook for International Bank Lending

Preface

In recent years world economic development has become critically dependent on the lending decisions of the leading banks that play a preponderant role in the international credit markets. In the absence of a mechanism for moving funds from surplus to deficit regions, the successive sharp increases in oil prices would have plunged the world into a deep depression. In the future, even if the OPEC surplus were to diminish quite rapidly, the current account deficits of non-oil developing countries are likely to remain large. Whatever changes take place in the geographical distribution of payments imbalances, large-scale imbalances are likely to persist. Indeed, the scale of these imbalances, and thus the volume of goods and services that developing countries can import to fuel their economic development, at any given level of exports, will themselves be determined partly by the volume of international bank lending.

Thus the Group of Thirty's study group on "Capital Movements and the Growth of International Indebtedness" decided that it should commission a major inquiry to determine the views of leading international bankers on the outlook for, and constraints on, new international bank lending and the functioning of the credit markets. This report summarizes the results. It forms a companion to the report of the study group already issued under the title, "Balance-of-Payments Problems of Developing Countries". That report analyzed the nature of the challenge facing developing countries in the aftermath of the second oil "shock" and made policy recommendations on the appropriate policy response of governments, the International Monetary Fund and the World Bank, as well as the private markets. This report analyzes the views of bankers themselves.

The report is based on written answers to a questionnaire made by 52 international banks and follow-up interviews with more than 30 banks: the interviews were held usually with the bank's chief executive or the head of its international department. The majority of the respondent banks are among the largest 100 banks in the world, including 20 of the top 50 banks, while an effort was also made to survey the views of smaller banks including regional banks with headquarters outside the main centers. The sample also included a few major investment banks and securities houses which specialize in arranging international bank loans. With regard to the geographical distribution of respondent banks, 12 were based in the United Kingdom, 11 in Japan, 7 in the United States (all these having assets of more than $14 billion), and 22 in continental Europe and other parts of the world.

The survey was compiled and edited by Mr. M.S. Mendelsohn, author of "Money on the Move: The Modern International Capital Market" published by McGraw-Hill. Interviews in the United States were conducted by Mr. Willard C. Rappleye, Editor of *Financier*, and those in Japan by the undersigned.

The members of the study group on "Capital Movements and the Growth of International Indebtedness" are

Mr. Jacques J. Polak, Executive Director, I.M.F. (Chairman);
Ambassador Roberto Campos, Brazilian Ambassador to the U.K.;
Mr. G.A. Costanzo, Vice Chairman, Citibank;
Professor Carlos F. Diaz Alejandro, Yale University;
Mr. David Holland, Chief Adviser, Bank of England;
Minister Cesar E.A. Virata, Secretary of Finance, The Philippines;
Dr. H. Johannes Witteveen, Chairman, Group of Thirty and former Managing Director, I.M.F.;
Mr. D. Joseph Wood, Director, FPA, World Bank;
Mr. Robert Pringle, Executive Director, Group of Thirty.

The work of this study group is supported by a grant from the Henry Luce Foundation.

Robert Pringle
August, 1981.

The Outlook for International Bank Lending

Introduction

Subjective reality has a force of its own and this report is based on the view that bankers themselves take of the modern international capital market.

Since the first oil "shock" of 1973, medium-term international bank loans and international bond issues have, on average, provided about two-thirds of the funds needed to balance the world's current payments plus additions to the reserves of the world's deficit countries(1)*. This can, admittedly, be little more than a guess because of the limitations of data on global payments, net new borrowing and net debt. But the market's preponderant role in moving funds from surplus to deficit countries seems universally accepted and its sheer efficiency as a transmission channel has so far helped to keep world demand and trade at higher levels than would have been possible in its absence. The central questions of this inquiry are whether bankers believe the market can go on fulfilling that role and how its efficiency might be improved.

The present report is based on answers to a questionnaire given by 52 leading international banks and their comments in subsequent interviews.

Most bankers questioned think that the international banking system is now in a better position to handle the recycling of OPEC and other surpluses because of the greater experience gained by banks and borrowers since the first quantum rise of oil prices in 1973. At the same time, however, a majority believe that the system may be working under more difficult conditions. Although the OPEC surpluses appear to have started diminishing rapidly once again, as in the mid-1970s, the continuation of such a contraction cannot be taken for granted. More important, perhaps, is that the deficits of non-oil developing countries are expected to remain very high for the foreseeable future, even assuming no further rise in real oil prices. This is a challenging prospect because many banks are thought to be running up against capital constraints, their lending limits to a number of borrowing countries and pressure on profits resulting from a squeeze on lending margins since 1976.

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* numbers in brackets refer to notes in the statistical appendix.

That squeeze has resulted mainly from competition among lenders. Indeed, one of the main themes of this report is the apparent contradiction between the constraints on lending complained of and the competition to go on lending, likewise complained of.

The main explanation for that and other apparent contradictions is that market participants cannot all have the same view at the same time because no market would exist if they did: this report certainly provides plentiful evidence of a wide diversity of views among lending bankers. And it has, indeed, been a characteristic of the international bank loan market since its uncharted beginnings in the mid-1960s that individual banks and national groups of banks have, periodically, participated in it more actively and less so according to their circumstances or those of the countries in which they are based. By the same token, access of borrowing countries has varied according to their circumstances: the market has, in effect, taken over much of the monitoring function once exercised exclusively and still exercised in a more formal way by the International Monetary Fund.

Constraints on lending

On the part of the banks, credit risk, capital adequacy and the profitability of international as against domestic lending are listed as the main constraints foreseen on the growth of international lending in coming years. But almost three-quarters of the bankers questioned described none of these as especially significant constraints. And, in spite of such constraints, a majority of banks questioned expect to increase the ratio of their international assets and earnings in relation to domestic assets and earnings over the coming years. This is particularly true of banks that have so far been relatively slow in building up their international business.

Although some bankers expect international loan losses to rise as a result of more reschedulings by sovereign borrowers, few expect that non-oil developing countries will run into a "generalized" problem, for all the difficulties of defining that concept precisely. Moreover, a majority of respondents believe that international loan losses will continue to run below the level of domestic losses, as in the past, partly because countries, unlike companies, cannot be wound up for creditors and nearly always service their debt over the longer term.

There is a seeming contradiction between the view expressed by a majority of bankers that lending margins will widen and the view of an even greater majority that this would not, in itself, compensate for higher risk or lead to an increase in lending. And it is, indeed, true that the volume of publicized new Eurocredit lending has levelled off since 1979. But that seems to have happened partly because many countries took advantage of easy terms for precautionary borrowing before the second, 1979, oil "crisis" and have since run down reserves and stand-by facilities. In addition, there has been a marked shift to more short-term international lending (of up to one year) since mid-1980. This may reflect greater caution by banks. But it may also reflect, in part, caution on the part of the borrowers about launching new development when real interest rates are at their highest since 1972, especially in the case of the dollar, the main currency of the international capital market.

True profitability

The profitability of a large wholesale market, but also the difficulties of calculating that profitability, are brought out in answers to question 10. They suggest that the true gross return to non-American banks is about 25 per cent above quoted lending margins and that returns on international dollar and Deutschemark medium-term loans are higher still for banks with wide deposit bases in those currencies.

The net-of-cost returns are, of course, considerably lower and the post-tax net returns lower still, in some cases as little as one-quarter of gross pre-tax returns. Those returns are, admittedly, no more than estimates because many banks admit that they cannot arrive at any precise costing of their international medium-term lending taken in isolation, since the allocation of overheads and other costs to any segment of a diversified enterprise is always arbitrary in part. Despite the imprecisions and misgivings, however, international banks have continued to compete for international lending business and most expect to go on doing so. They would not be, unless this business offered higher rewards than the alternatives available. An almost inescapable conclusion is that the volume of new international bank lending will go on being determined by relative demand between domestic and international borrowers.

Any worries?

Aspects of the market that trouble some bankers, though by no means all, are the possible instability of excessive concentration of liabilities (heightened by the shift of new Iranian dollar earnings to non-American banks in 1979/80), and a general trend towards shorter maturities and more volatile currency switching by depositors as a result of sharp swings in American interest rates since October, 1979, and related fluctuations in other leading financial centers. This can complicate the funding of three- and six-months rollover periods of medium-term international loans, but most banks seem to think the problem manageable.

When it comes to improving the system's efficiency, most banks believe that they, themselves, cannot offer depositors any significant inducement to stretch out the maturity of their financial assets in a climate of high inflation and unpredictable interest rates, but that the International Monetary Fund could contribute to an expansion of a market in SDR assets, as yet in its infancy. Most bankers believe that the IMF could raise considerable additional funds on the markets if it wished. However, some oppose the idea for fear that the Fund might "crowd out" banks in the international financial markets. Relevant in this respect is the distinction which bankers draw between the Fund's role of tiding member countries through temporary adjustment, and the market's role of financing development promising borrowing countries a rise in their net foreign exchange earning capacity over the longer term. And, while bankers believe that it would be in the interest of borrowing countries (and not lenders alone) if more information about members were authorized through the IMF, the scope for "co-financings" seems limited to most of them.

What emerges is the picture of a market that has grown very considerably in the past dozen years in spite of periodic misgivings voiced by many of its participants and one which most bankers expect to go on growing in spite of difficulties some of them foresee. It does not follow that the market is without dangers of any kind, but its participants should be judged by their deeds and the functioning of the market by its results.

The Outlook for International Bank Lending

Questionnaire for International Bankers

1. In your judgment, is the international banking system in a better or worse position to handle the "recycling" of OPEC funds now than it was in 1974-76?

2. In this respect, what do you consider to be the most important difference between the first and second rounds of recycling?

3. Last time, the current surplus of oil-exporting countries was rapidly reduced, from about $68 billion in 1974 to about $5 billion in 1978. Do you anticipate that their current surplus will again be reduced rapidly, over the next five years or so, or do you anticipate a longer period of massive surpluses?

4. Do you anticipate that OPEC depositors will stretch out their investments into longer-term assets more rapidly on this occasion than in 1974-76?

5. What is your attitude to the acceptance of short-term OPEC deposits? Do you think that banks can provide incentives towards a larger investment in longer-term assets?

6. The following is a list of some possible constraints on the expansion of international lending by banks. Could you please indicate which will be significant constraints on lending by your bank?
   a. Anticipated relative (un)profitability of international vs. domestic lending;
   b. Concerns related to capital adequacy;
   c. Credit risk and undue concentration of risk;
   d. Attitudes or policies of national bank supervisory authorities;
   e. Other official restrictions or regulations;
   f. Other (please specify).

   If possible, please rank in order of significance.

7. Is your bank's lending to particular international borrowers at present constrained by the extent of outstanding commitments to individual borrowers in relation to capital funds?

8. If your bank has a sizeable commitment in a particular country (by way of branches, outstanding credits, etc.) does this factor provide an incentive to extending new credits to borrowers in that country?

9. Last time, no serious defaults arose. This time do you think that a generalized debt problem affecting developing countries is likely to emerge, and if so, in what way would it emerge?

10. To what extent do commercial bankers believe that increased spreads would compensate banks for higher risks, and help induce additional bank financing? To what extent do they expect spreads to rise?

11. On the side of the LDC borrowers, do you think that there is the potential for a large increase in bond issues by developing countries? If so, which of the bond markets offers the greatest potential for further expansion?

12. Do you think that banks' underlying bad debt experience and loan write-offs will be better or worse on international loans than on domestic loans (on average over the next four to five years)?

13. Turning to your bank's activities, do you anticipate a large increase in your international business? Specifically, do you anticipate that the ratio of the bank's international assets to total assets (on a world-wide consolidated basis) will increase or decrease in the course of the next two to three years (from end-1979)?

    a. Increase of more than 20%
    b. Increase of 10-20%
    c. Increase of 0-10%
    d. Decrease of more than 20%
    e. Decrease of 10-20%
    f. Decrease of 0-10%

14. What was your ratio of international to total assets

    a. At end-1979?
    b. At end-1978?
    c. At end-1974?

15. Do you anticipate that the ratio of international earnings to total net earnings will change appreciably over the next two to three years?

    a. Appreciable increase
    b. Appreciable decrease

16. In general terms, is there a maximum limit to the ratio of international to total assets which you would not like your bank to exceed, over the longer term? If so, could you indicate what the maximum would be?

17. The regulatory authorities in the United States have developed a system for drawing their banks' attention to credits which in their opinion may carry undue risks and for generally supervising US banks' international lending. Do you approve of their approach to bank supervision or not?

18. (For banks with head offices outside the United States) In your opinion, will the system of bank supervision applied to your bank by your national supervisors have the effect of slowing down the rate of expansion of your international lending below the rate you would yourself consider prudent?

19. On the liabilities side, do you feel that greater uncertainty with regard to the stability of the deposit base (in terms of possible shifts in the geographical distribution or currency distribution of new deposits, for example) will act as a deterrent to new international lending?

20. Would your bank consider offering facilities whereby deposit-liabilities would be denominated in a "basket of currencies", such as the SDR, as a means of offering a more stable asset to customers?

21. What do you believe is the appropriate long-term relationship between the IMF and commercial banks with respect to information sharing, cofinancing, and basing future bank lending on compliance with conditions in IMF agreements?

22. Would you favor some easing in the conditions attached to IMF credits to encourage borrowers to go to the Fund at an earlier stage than has usually been the case in the past? Or would you, on the contrary, be very concerned at such a policy trend?

23. Do you think that the Fund itself would be able to borrow large amounts on the international financial markets and what, in your view, would be the best approach for the Fund to follow?

24. When the Fund reaches an agreement with a member country on the adoption of an adjustment program, as part of a credit facility, would you regard this by itself as a decisive factor in your bank's decision to extend new credit to that country?

25. Other possible measures that have been suggested for easing the strain of recycling on the banks include the following:

    a. The establishment of an international agency to provide insurance facilities for bank loans;
    b. The establishment of an agency to provide official medium-term finance.

    Do you favor either of these?

Survey of Market Opinion

1. In your judgment, is the international banking system in a better or worse position to handle the "recycling" of OPEC funds now than it was in 1974/76?

Respondents' Answers
(per cent)

Better Position	*Worse*	*Better and Worse*
17	51	32

As shown above, a majority of respondents think the banking system in a worse or partly worse position to handle the recycling of OPEC surpluses than after the first oil "shock"; but almost half of all respondents think the system better or at least partly better placed.

More relevant, perhaps, than the difference of emphasis is the wide agreement by banks on the reasons for their views. Most believe the system to be better placed for having gained greater experience. At the same time most believe it to be in a worse position because many banks are thought to be running up against capital constraints, lending limits to a number of borrowing countries, especially oil-importing developing countries, and pressure on profits resulting from the squeeze on lending margins created by competition to go on lending.

Reasons given for thinking the system *better placed* than in 1974/76 include the following:

1. Banks have become better informed about country risks, partly on the improved flow of information from official sources and partly on a refinement of risk analysis within commercial banks themselves;
2. The above is said to have contributed, in turn, to an improved grading of lending limits within banks;
3. The banking system involved in the recycling process is said to have improved greatly in size and depth through an increase in the number of banks providing international medium-term credits, closer links between banks that have often participated with each other in lending syndicates, and through the evolution of regional lending centers, especially in Asia, where closer and more continuous contact with borrowers has been made possible;

4. As in the immediate aftermath of the 1973 oil "shock", the biggest deficit countries in 1980-81 have been the leading industrial countries, but with the important difference that the two biggest deficit countries after the latest rise in oil prices have been the relatively strong economies of Germany and Japan, which have been able to finance part of their deficits directly from the OPEC authorities which allowed the market, in turn, to give priority to other industrial deficit countries perceived as good risks;

5. A difference cited by some banks has been the absence on this occasion of the uncertainty which followed the collapse of 1971/73 world economic boom and its accompaniment of crisis and failures in the foreign exchange, shipping and property markets;

6. In the opinion of some banks, many borrowers have learned to improve the structure of their foreign debt and more have learned to take advantage of favorable market conditions for precautionary borrowing;

7. Finally, many banks cited the greater willingness and speed shown by many countries in adjusting to higher oil prices following the second round of significant real oil price increases.

This last point is, perhaps, the most important in macro-economic terms. The size of the imbalance in global current payments depends in part on the deficits that countries are prepared and allowed to run. That, in turn, helps determine the surpluses that other countries can earn and hence the volume of recycling, the accumulation of external assets on the part of surplus countries and of external liabilities by deficit countries.

Reasons for thinking the system *worse placed* than in 1974/76 include the following:

1. The system as a whole is thought to have become over-exposed to some borrowers, especially some developing countries, and more banks are said to have reached or come close to statutory or self-imposed lending limits to such borrowers (although this is contradicted by several banks which point out that lending limits are not immutable, but are adjusted according to the changing circumstances of borrowing countries);

2. In the United States and Japan, where bankers tended to somewhat more concern than their European colleagues, several questioned the ability of dollar markets and dollar-based banks to go on taking as large a part as before in the intermediation of OPEC funds;

3. The cost of debt service has been increased by the rise in American and other key interest rates and, in the opinion of some respondents, relatively high interest rates may persist for some time;

4. Banks have become less well capitalized and face difficulties in restoring their ratios of capital to assets in the present climate of highly volatile interest rates and the pressure on bank profits in some leading Western countries;(2)

5. There are poor prospects for the maintenance, let alone real increase, of official flows to developing countries (this tends to affect mostly the poorer countries with limited market access or none);

6. The liquidity of the international banking system continues to create intense lending competition ("artificially so" in the words of one bank) with resulting pressure not only on average lending margins, but also on differentials between margins to prime and lesser borrowers, pressure on some banks to make marginal loans they might otherwise refuse, and pressure also on other lending terms, as in the form of longer maturities or reduced fees, all contributing to pressure on the profitability of international lending;

7. The volatility of short-term interest rates, especially dollar interest rates, is said to have increased the difficulties of maturity transformation on the part of some banks which are unable to obtain sufficient three-months liabilities to match fully the conventional three-months rollover periods of most medium-term international loans. It has also increased the difficulties, and opportunities, of those banks who choose not to match fully on their view of interest rate trends in the short-run, although that latter practice, to the extent that it exists, would result from a decision by banks to seek opportunities at a high risk rather than from the volatility of interest rates themselves;

8. Since the early 1970s, international lending has grown faster than domestic lending at many leading international banks and, in the opinion of some, this could limit the further growth of international lending in relative terms (although other banks cite demand as the determinant of lending);

9. Some banks, locked into some large borrowers, will have less capacity to lend to others but that might influence the composition of lending banks rather than the total of market flows;

10. Closer internal controls by banks and closer supervision by the authorities in the main financial centers might slow the growth of international lending, at least to some borrowers.(3)

2. In this respect, what do you consider to be the most important difference between the first and second rounds of recycling?

The gist of the answers given by many bankers, taken with the answers to the preceding question and the following question, is that the *system* is believed to be better than last time but the *circumstances* are more unfavorable.

This is illustrated in the points listed below, which are included among answers to Questions 1 and 3:

1. One difference perceived by several respondents between the aftermath of the first and latest oil "shocks" is that demand in the industrial countries as a group may remain depressed for a longer period this time. If that proves the case, it would contribute to a slowing of export growth of higher income non-oil developing countries and countries in Eastern Europe, while at the same time increasing their debt service ratios. Such countries might not, in those circumstances, be able to maintain borrowing at previous levels for continuing development. This might be particularly true if excessive dependence on monetary constraint in the industrial countries, resulting from the difficulties of imposing fiscal policies, adds still further to unemployment in the OECD area. Rising unemployment could then add still further to protectionism whether directly, through subsidies to declining industries and regions, or by some combination of such approaches;

2. A more positive difference mentioned by some respondents is the growing flexibility of the international capital market. For about two years past there seems to have been an increase in single bank to single customer international medium-term bank loans, although the evidence for this is necessarily impressionistic. More international bank loans are now based on US prime instead of the conventional Libor, or some combination of the two or options between them. The use of the US bankers' acceptance rate was

recently introduced as yet another base for floating rate medium-term international bank loans. Another innovation has been the inclusion of an SDR tranche in a recent international bank credit, and ECU tranches in others;

3. In the international bond markets, issuing volume has been kept up by large numbers of convertibles, floating rate notes, bonds linked to world oil prices, low coupon bonds sold at heavy discounts to bring yields to market levels, comparable bonds with fixed coupons but with issuing prices left to market demand and other innovations like "bought in" issues taken up whole by managing bank syndicates on the speculation of selling them to investors. While a return to more stable interest rates can be expected to lead to a return of more conventional fixed-interest financing on international bond markets, the experience gained of more flexible approaches could again prove useful in any future periods of volatile interest rates;

4. A difference or, at least, evolution since the middle and latter 1970s consists in the growing proportion of new Eurocredit borrowing used to finance maturing debt. According to estimates made publicly by the Deutsche Bank, that proportion approximately doubled to about half between 1978 and 1980 and might, on present trends, grow to about two-thirds by 1985. One implication seems to be that countries which borrowed heavily mainly for development may have to devote an increasing share of new borrowing to the completion of development already started unless they can increase their borrowing for additional development. They might be able to do the latter only if lenders were confident that additional investment would contribute further to the economic growth, export potential and debt servicing capacity of the borrowing countries;

5. A difference stressed by bankers in Japan was the greater trend they perceived towards diversification of OPEC funds both by currency and maturity, compared with the first round of recycling. On some Japanese estimates, the equivalent of at least $10 billion of OPEC funds had been placed in the Tokyo market in yen in 1980 predominantly in longer-term forms (some estimates put the total much higher), and the inflow was expected to continue in 1981. Corporate as well as government bonds and even equities were being acquired by overseas official holders.

3. Last time, the current surplus of oil- exporting countries was rapidly reduced, from about $68 billion in 1974 to about $5 billion in 1978. Do you anticipate that their current surplus will again be reduced rapidly, over the next five years or so, or do you anticipate a longer period of massive surpluses?

Only a minority of bankers questioned in the United States, Japan and Europe said, when questioned in the spring and early summer, that they believed the OPEC surplus would again be reduced rapidly. Since then, official estimates and forecasts seem to have contradicted that view, at least for the short term of this year and 1982; the combined OPEC surplus is expected by OECD to decline from $120 to less than $70 billion between 1980 and 1982. However, this is expected to be a reflection mainly of an improvement in the position of the main industrialized countries. The combined deficits of non-oil LDCs and other non-OECD countries is expected to rise from about $50 billion to about $65 billion between the two years. While the official estimates and forecasts therefore contradict the majority view of bankers questioned in this survey, they do confirm the belief expressed by a majority of those bankers that non-OECD deficits may persist at a high and even rising level. (4)

4. Do you anticipate that OPEC depositors will stretch out their investments into longer-term assets more rapidly on this occasion than in 1974/76?

There was a clear distinction between the answers given to this question by *European bankers*, about three-quarters of whom believe OPEC investors will *not* stretch their investments more rapidly than after 1973, and a majority of respondents in the *United States* and *Japan* who gave the opposite answer. This view was particularly strong in Japan, where all respondents thought OPEC investors would increase their long-term investments quite rapidly. They based this view on the experience of large OPEC yen investments in 1980, already referred to in the answers of Japanese banks to Question 1. Japanese banks believe the OPEC authorities wish to increase the currency diversification of their assets so as to hold a lower proportion in dollars. But short-term financial markets in currencies other than the dollar were limited, they said, so that OPEC investors were being pulled into longer -term investments in the case of the yen.

In contrast, even the minority of European respondents expecting some stretching out of OPEC investments into longer-term assets were unanimous in saying that they thought this would be a slow and marginal process.

Observations made by European and associated bankers include:

1. Longer-term financial assets will remain unattractive as long as inflation persists in the industrial countries accompanied by exchange and interest rate instability;
2. Apart from government securities markets in some of the main Western financial centers, there are no financial markets of sufficient size which could provide long-term investment opportunities as well as liquidity for any significant proportion of OPFC investments;
3. OPEC authorities and institutional investors will maintain a strong preference for liquidity on political as well as investment grounds, the former reinforced by the American freezing of Iranian assets during the hostage impasse;
4. Although rich individuals in OPEC countries invest some of their portfolios in gold, this market is likewise too small to provide liquidity for significant investment by OPEC authorities and institutions. These would,

moreover, be shifting from oil, an asset whose price they can control, into gold, whose price they cannot control because non-OPEC authorities hold about 40 years' of current gold output. It is true that official OPEC gold holdings rose by about 17 per cent to about 40 million ounces of gold in just over four years, to March, 1981, mainly on purchases by Indonesia, Libya and Saudi Arabia. But this still left gold at less than 5 per cent of OPEC reserves, even at recent gold prices;

5. Although respondents envisaged some further foreign direct investment, including real estate acquisitions by OPEC investors, such investment is expected to remain limited by opposition or supposed opposition to "Arab take-overs" in host countries and by caution on the part of OPEC investors about possible seizures;

6. Some banks report that the maximum maturity of some OPEC deposits has doubled in the past two years to 5- and even 6-year deposits, but the proportion remains extremely small because of the illiquidity of such deposits, which applies even to large holdings of medium-term certificates of deposit (CDs);

7. An example of the maturity structure of OPEC deposits given by a major European international bank is typical of similar breakdowns given by other banks:

Maturities of OPEC Deposits at European Commercial Bank
(per cent)

call/30 days	*1/12 months*	*over 1 year*
40	*57*	*3*

8. Some banks made the point that the continuing renewal even of the shortest-term OPEC deposits represented, in effect, a form of medium to longer-term depositing. But *confidence in the uninterrupted renewal of such deposits in the case of any single bank is less than wide-spread* and, even at best, banks may rely on some given volume of liabilities, but not their cost;

9. Several respondents said that OPEC authorities and institutional investors might be tempted into index-linked medium and longer-term assets, but that such assets could be provided only by official sources.

5. What is your attitude to the acceptance of short-term OPEC deposits? Do you think that banks can provide incentives towards a larger investment in longer-term assets?

Banks were divided in their attitudes to highly concentrated very short-term OPEC deposits, but almost unanimous in their view that banks themselves can do little to provide incentives for larger OPEC investment in longer assets.

Attitudes to short-term deposits include:

1. Short-term OPEC deposits present no problem and can be preferable in being marginally cheaper than comparable funds drawn from the interbank Eurocurrencies market;

2. Very short-term OPEC deposits can present a problem because such funds flood in when OPEC authorities receive oil payments and flood

out when OPEC depositors make large import payments. In making this point, one bank said, "Such deposits are acceptable but not desirable because of their volatility;"

3. One bank observed it welcomed very short-term OPEC deposits for funding trade financing, but less so for transformation into medium-term assets;

4. One bank reported that it was not concerned about a heavy concentration of very short-term deposits from OPEC or other sources when that fitted with its funding requirements of the moment, but that it turned down excessive offers of such deposits at other times either by quoting returns unacceptable to the prospective depositors or by outright refusal.

Comments on the ability of banks to provide incentives for longer-term OPEC deposits included:

1. "Providing incentives for greater investment in longer-term monetary assets is entirely a matter of market forces and depositors' perceptions of exchange and interest rate trends; banks themselves cannot provide any incentives";

2. A comment in similar vein was: "The only incentive is the market rate, which is acceptable to depositors or not." And, more briefly: "Banks are helpless";

3. Some banks said that the development of an SDR market might help attract more medium to longer-term OPEC deposits (see answers to Question 20);

4. Some banks thought further development of the floating rate note market might help attract longer OPEC deposits, though even that on a limited scale, and at least one bank observed that it regarded the issue of floating rate notes as an expensive way of funding itself;

5. Another reservation expressed about the potential of floating rate notes and certificates of deposit as an attraction for OPEC authorities was the investment that would be required in expanding not only the primary market for such paper, but the need also to ensure a large and liquid secondary market;

6. A different approach, suggested by one respondent, was that banks might do more to help OPEC clients find suitable longer investments rather than trying to provide such assets themselves.

7. Some bankers in the United States said that they had placed tight constraints — and in some cases absolute ceilings — on the acceptance of short-term deposits by OPEC countries in order to maintain proper diversification.

8. Several respondents commented on the effect of the freeze on Iran's assets: "They must be thinking about that all the time, and maybe that overrides any lean toward long-term deposits."

6. The following is a list of some possible constraints on the expansion of international lending by banks. Could you please indicate which will be significant constraints on lending by your bank?

a. Anticipated relative (un)profitability of international vs. domestic lending;

b. Concerns related to capital adequacy;

c. Credit risk and undue concentration of risk;

d. Attitudes or policies of national bank supervisory authorities;
e. Other official restrictions or regulations;
f. Other (please specify).

If possible, please rank in order of significance.

A majority of respondents described none of the constraints as especially significant, about half listed only some of the constraints, and some listed none.

In that context, credit risk emerged as the most important constraint, followed by capital adequacy and relative profitability of international lending.

In summary:

a. *relative profitability* was listed as a constraint by almost 80 per cent of respondents and by 33 percent as the second most important.
b. *capital adequacy* was listed as a constraint by 70 per cent of respondents and by 50 per cent as the second or third most important;
c. *credit risk* was listed as a constraint by 75 per cent of respondents and the most important by 70 per cent;
d. *supervisory attitudes* were listed by 60 per cent of respondents as a constraint and by 40 per cent as the third or fourth most important;
e. *other official restrictions* were listed as a constraint by 30 per cent of respondents, mostly as the fourth or fifth most important;
f. *unspecified constraints* were listed by only 6 per cent of respondents; among these, shareholder relations, debt restructuring problems, and "funding risk" were cited.

7. Is your bank's lending to particular international borrowers at present constrained by the extent of outstanding commitments to individual borrowers in relation to capital funds?

Respondents' Answers
(per cent)

yes	*no*	*n.a.*
20	72	8

Most non-American banks do not limit their commitments to individual borrowers in relation to their own capital funds; the ways in which they set their own prudential limits are described in the answers to Supplementary Question 1A on page 43. However, even half the U.S. banks questioned said their lending was not at present constrained by outstanding commitments, which were still within statutory limits.

Among the minority of respondents who answered "yes" to Question 7, above, was a German bank which said that loans and commitments to its five major borrowers combined might not exceed three times its own capital and reserves and that the total of its disbursed loans might not exceed eight times its own equity capital, under Paragraph 13 KWG — the German Law of Credit System.

It will be seen, however, that this is not a direct answer to the question because one part of it concerns the total of loans and commitments to a group of clients and another part covers the total of loans to all clients. Neither part of the answer relates loans and commitments and the bank's capital funds in respect of any *individual* borrower.

Of the other German banks that responded, one answered "partly" and the remainder simply answered "no."

However, within the sample as a whole, some banks indicated that although they did not at present limit commitments to individual borrowers in relation to their capital funds, they might do so if any such commitments rose to an amount making such limitation appear prudent.

8. If your bank has a sizeable commitment in a particular country (by way of branches, outstanding credits, etc.), does this factor provide an incentive to extending new credits to borrowers in that country?

The answers to this question were fairly evenly divided between respondents answering "yes" and "no" but the reasons given varied.

Among those banks that said existing commitments would not in themselves induce them to make still more, several hedged their answers, especially in interviews. One of these said "not in principle, but sometimes in practice"; another said "sometimes our arm can be twisted moderately"; another said it sometimes made new commitments on the basis of existing ones, "but reluctantly."

A more positive answer given by several banks was that the very decision to open branches in a foreign country implied a judgment about opportunities and a reasonable absence of country risk which would, of itself, encourage growth of lending to that country.

The point was put differently by one bank, which said that the knowledge and experience of a country gained through branching in it could provide an incentive to lending that other banks might not be willing to consider for lack of similar knowledge and experience, "although that can, of course, also work in the opposite way."

A distinction was, however, made by several banks between the influence on new lending made by existing commitments in the form of branches and outstanding credits. Several said that heavy credit exposure would not in itself induce still more lending and might, indeed, have the opposite effect.

Among the banks that said existing commitments would not in themselves lead to new commitments, all said that the decisive factor was the country lending limits they had set themselves rather than the extent of the commitments already made. However, they pointed out that the extent of existing exposure, by way of branches or of outstanding credits, was of course an important aspect in determining country limits. From this it follows that the difference between respondents answering "yes" and "no" is shaded rather than sharp, and that existing commitments have an influence on decisions to extend new credits, although they do not necessarily provide an incentive to do so.

9. Last time, no serious defaults arose. This time do you think that a generalized debt problem affecting developing countries is likely to emerge, and if so in what way would it emerge?

Respondents' Answers
(per cent)

yes	*no*	*possibly*
15	72	13

The necessarily simplified breakdown of answers above needs to be qualified. Many banks which said they do not foresee a generalized LDC debt problem nevertheless foresee more reschedulings. Most of those banks therefore raised the obvious question of definition: at what point might an accumulation of reschedulings become a "generalized" problem? None of the respondents believed they could satisfactorily identify that point, in their written answers or interviews. Nor was a precise definition attempted by the minority which thinks the number of reschedulings will grow to the point of constituting a "generalized" problem.

There was greater precision on the part of some banks which said a generalized problem might arise if default or rescheduling by one or more major borrowers created a crisis of confidence in the market as a whole, similar to that which followed the Herstatt collapse in 1974. However, although none of the respondents to this question said so, it seems worth recalling that the Herstatt crisis righted itself fairly quickly, because large banks, inundated with funds withdrawn from smaller banks, had no alternative but to put them back into the interbank market, whereupon rates for all banks soon returned to normal levels. In the different crisis of confidence envisaged as a possibility here, it would remain to be seen whether banks really would react to a setback by putting their other assets at a greater risk too.

A different reason given for envisaging the possibility of a generalized problem was that it might evolve if borrowing by a large number of higher-income developing countries did not continue to generate foreign exchange earning or saving capacity. This could arise, in the view of many bankers, as a result of prolonged recession, unemployment and growing trade protectionism in the industrial countries.

On the other hand, some respondents thought the risk of serious defaults or reschedulings may have been reduced by the greater budgeting experience acquired by sovereign borrowers since the mid-1970s, as well as the greater experience of sovereign lending acquired by banks.

Another point made was that the highly concentrated exposure of international banks, especially American banks in some areas of Latin America and Asia, would cause those banks to "take very determined steps indeed" to ensure that the borrowers maintained their viability.

As interesting as the answers to this question was the omission of any reference to Poland both in written answers and in interviews with European bankers (where the question was deliberately not raised to discover whether any bankers would volunteer opinions on the matter). The omission is intriguing because Poland is the first major borrowing country to which lending was maintained far beyond the point at which an economic adjustment was feasible excepting over the medium term of several years. In most cases, there has been a pattern of temporarily shutting countries out of the market before such a stage is reached and Poland itself was, indeed, shut out of the market, but only briefly in 1977.

Some comments worth quoting include the following:

> "By agreeing with the word 'generalized,' we are not suggesting that a general and coordinated LDC default is in the cards. The more likely pattern is for debt-management difficulties to arise in several countries, but in no way coordinated, and not occurring simultaneously."
>
> "There are problems, and we constantly monitor them. But basically our lending is to about ten countries, which we watch like a hawk for the investments they are making and their ability to service debt, and when a country does not appear to be making the right policies or correcting the disequilibrium in the balance of payments, we pull out pretty quickly."
>
> "Several large borrowing countries rescheduled in the 50s and the 60s; but with all the oil problems they didn't reschedule in the 70s, and it was not an accident. They are a lot better run now. You really had to worry in the 50s because of the crazy management in those countries. We have been able to lend to some large borrowing countries because they have evolved to the point where they have developed the management necessary to create economic growth. If those countries had the same kind of management they had in the 50s they would have zero growth, and we would not be lending to them today."

On this question, however, Japanese bankers stood out as somewhat more pessimistic than American and European bankers. Not only did most of them expect more *de facto* defaults, but some also expected a generalized problem to emerge. One bank said that in its opinion a "chain reaction" of defaults was "likely."

10. To what extent do commercial bankers believe that increased spreads would compensate banks for higher risks, and help induce additional bank financing? To what extent do they expect spreads to rise?

Respondents' answers (per cent)			
	yes	*no*	*n.a.*
Will spreads widen?	62	21	17
	yes	*no*	*partly*
Would wider spreads increase lending?	2	70	28

While a majority of bankers go on hoping that spreads may widen, although they have in fact been narrowing since 1976, most say that wider spreads would compensate only in part for higher risks and would not, in themselves, induce them to increase their international lending. Some said, however, that wider spreads might help induce them to maintain such lending. (5)

The main reason given by bankers who *expect spreads to widen* in the next year or two is that rising costs and growing constraints on capital ratios will force more banks to hold out for more favorable lending terms. However, some respondents hedged this answer by saying that terms would harden only if enough banks declined to compete for, or actually turned down lending participations at margins thought to be inadequate; they added, however, that they could not be sure that this would actually happen.

Nearly all bankers who expect spreads to widen think that they may *widen for some borrowers only, and slowly* at that. The most common view is that spreads may widen for weaker borrowers. One bank, however, forecasts static or even still narrower margins for prime borrowers, some further erosion of margins for secondary names thought not to be overborrowed, and some widening of margins only for the weakest borrowers.

The minority of banks, which expect that spreads will *not widen*, said a persistence of high international liquidity and competition between banks would go on working in favor of borrowers. One of these banks defined both the average and differential width of lending margins as factors of international money market conditions rather than perceived lending risks.

The majority of respondents who think there will be *little or no increase in lending*, least of all to marginal borrowers, even if spreads do widen, includes a number who think a widening of spreads might maintain the volume of new medium-term international bank lending. Some banks said bigger margins might induce them to increase their lending to prime names, but nearly all said that larger spreads would do very little if anything to make lesser credits more attractive. "An extra 1 per cent spread cannot compensate for an extra 50 to 100 per cent increase in risk" said one respondent.

Supplementary questions asked at this point, in the course of interviews, concentrated on the true returns on Eurocredits, as estimated by non-American banks.

It is well known that lending margins are an indication rather than measure of the return to banks on Eurocredits. Large banks may obtain interbank funds at lower cost than the Libor deemed to apply to a lending syndicate as a whole. Some syndicate members may have access to deposits from the authorities and state agencies of countries outside OPEC and the Group of Ten at a cost below Libor. And some banks may have an interest free (though not cost free) deposit base in the currency used for international lending (mostly American banks in the case of the dollar, but also German banks in the case of the Deutschemark, in which a sizeable minority of medium-term international lending is made). The average cost of funds to most banks in a Eurocredit syndicate is therefore at varying levels below the base rate above which lending margins are fixed. Additional income, most of which goes to managing banks, is derived from arrangement and front-end commitment fees.

Taking those factors into account, but excluding any allowance for the unquantifiable additional advantage of other business gained or kept as a result of Eurocredit participation, non-American banks estimate their true return on Eurocredit lending in a range of 0.2 to as much as 0.75 per cent above lending margins, with a majority estimating that return at about 0.25 per cent above (i.e., a *true gross return of 1.25 per cent on a quoted lending margin of 1 per cent*).

On the same basis, a major American bank estimated the *true gross return in leading a Eurocredit syndicate at up to ½ point above a quoted spread of 1 per cent.*

A true gross return of *1½ to 2 per cent above quoted margins on international Deutschemark loans* was cited by a leading German bank, which estimated its return on such loans at up to 2½ per cent above its average cost of dm funds.

A second supplementary question put in interviews, asked non-American banks to estimate their *break-even-point on Eurocredits*. Most cited a minimum quoted margin of *⅓ per cent above Libor* plus some element of front-end fees, but some said their break-even was ½ to ¾ per cent above Libor, the latter, however, including fees.

An important qualification is that the true gross returns and estimated break-even points cited above are in all cases *pre-tax*. Taxes paid by banks vary according to location, but an example of the impact was given by a leading French bank. It estimated its true gross return on a 1 per cent margin above Libor at *1 ½ per cent*, but at only *0.65 per cent net of costs* and *0.40 per cent net of costs and tax*.

Another qualification, applying to banks everywhere, is that *rising costs* give banks no assurance about their returns on medium-term international loans, however those returns are measured, nor on those loans attempting some allowance for rising costs by means of margins rising over the life of the loans.

However, the most important qualification, which compromises, without wholly invalidating everything reported above, is that many non-American banks say that they cannot monitor the marginal cost of their dollar funds as efficiently as US banks participating in Eurocredits. Moreover, many banks say that they cannot arrive at any reliable costing of their medium-term international lending business taken in isolation and at least one bank said it had never ever attempted the exercise. The reason is that the allocation of overheads and other costs to any single segment of a mixed enterprise is nearly always arbitrary, at least in part, and banking is no exception. It follows that the estimates quoted above of true gross returns on Eurocredit lending, true net and true post-tax returns as well as break-even points are, in all cases, best described as no more than guesstimates.

A third supplementary question put at this stage in interviews asked what *provision* banks made against their medium-term international exposure. Most answered that they provide against such international risk on the same basis as against all classes of risk and that they provide against international risk within their general provisions, without segregating provision against Eurocredit assets.

A major European commercial bank said it maintained an historic average of 0.3 per cent of all external assets in the form of contingency reserves, including claims on sovereign borrowers. An international consortium bank said it maintains such reserves at an average of at least 0.75 per cent.

Provision is, however, graded according to risk on all classes of assets. For instance, a large European international bank makes provisions ranging from zero against "risk free" assets like gold and the securities of lending governments, to 2 per cent against claims on some developing countries. Another large bank similarly makes no provision against "risk free" assets but does not usually include in its general provisions more than 1 per cent against any single asset, of whatever kind. A third bank holds provisions ranging from zero upwards against 10 categories of risk, making specific provisions in the currencies at stake in the case of its riskier assets. Only one European bank reported that it made a separate and differentiated provision against each individual international medium-term loan in which it takes part, although that provision is nevertheless added into its general reserves.

In all cases the common banking principle applies: that provisions which prove to be unneeded for some contingencies become available for others.

11. On the side of the LDC borrowers, do you think that there is the potential for a large increase in bond issues by developing countries? If so, which of the bond markets offers the greater potential for further expansion?

Respondents' Answers
(per cent)

large increase	*limited*	*little or none*
12	24	64

A majority of respondents believe that the international bond markets offer a source of financing only for a limited number of LDCs, predominantly OPEC borrowers and NICs (newly industrialized countries); that the markets provide such financing only in conditions of relatively stable interest rates and yields; that most LDC borrowers would need international guarantees of some kind; and that what potential there is lies mainly in the less regulated Eurobond markets.

The record tends to support such views. (6)

LDC borrowers first entered the international bond markets (Eurobonds plus foreign bonds) on any scale that mattered in 1976. The volume of their borrowing then rose appreciably in absolute terms, as a proportion of total international bond issues and as a proportion of borrowing by LDCs on the international bond and credit markets up to 1977/78, when issuing conditions were favorable on world bond markets.

By 1977, international bond issues accounted for 15 per cent of international market financing by LDCs (bonds plus credits) and more than 12 per cent of all international bond issues by 1978.

The pronounced decline in new LDC issues since 1979 does show, however, that the international bond markets appear to offer scope for LDC borrowing, as yet, only when market conditions are generally favorable.

While about 15 LDCs have so far tapped the international bond markets, they have indeed been limited to NICs and OPEC borrowers; non-

OPEC borrowers have predominanted only because they include Mexico, a large oil producer. Other prominent LDC borrowers have included Algeria, the United Arab Emirates and Venezuela, among the OPEC countries, plus Brazil, the Philippines, Singapore and Thailand.

Such borrowers have not needed international guarantees, but they do pay a premium which, on the external Deutschemark bond market, recently ranged from about 200 to 250 basis points above yields for comparable maturities of prime European borrowers.*

However, such premiums appear worth paying to the borrowers not so much, perhaps, for the relatively limited funds at present available to them on the bond markets directly, but because access to international bond markets is widely regarded as reinforcing the credit standing of borrowers and is thus thought to contribute to their ability to secure more favorable terms on the international bank loan market.

Among the minority of respondents to this question Japanese bankers and especially investment bankers were more interested in the potential for an increase in bond market financing than their counterparts in Europe and the United States, in the context of the relative increase in the volume of yen-denominated bond issues by foreign borrowers generally. They acknowledged that the scope for a large increase in issues by developing countries in the short term was limited (the authorities require borrowers to have made two issues on other markets before), but some LDCs had made issues last year, and from the point of view of the "recycling" of OPEC funds, what mattered was rather the availability of a long-term market for borrowers and investors in general. A very large expansion in Samurai bonds could be expected if the Ministry of Finance were to relax its guidelines because of the attraction of Japan's relatively low interest rates. Opinions differed about whether the present restrictions were required from the point of view of maintaining an orderly market.

12. Do you think that banks' underlying bad debt experience and loan write-offs will be better or worse on international loans than on domestic loans (on average over the next four to five years)?

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*On the external DM bond market at end-June, 1981, Pemex 7 per cent 1986 was yielding 12.15 per cent against a yield of 9.65 per cent on EIB 7¾ per cent 1986 (a difference of 250 basis points); Commission Federal Electricidad (Mexico) 6¼ per cent 1988 was yielding 11 per cent, against a yield of 8.90 per cent on Eurofima 5½ per cent 1988 (a difference of 210 basis points).

Respondents' Answers
(per cent)

better	*worse*	*n.a.*
71	7	22

Although the great majority of respondents think that international loan losses will continue to be less than domestic losses, several believe there might nevertheless be some increase in international losses in relation to losses on domestic lending, and this is especially true of Japanese bankers.

The main reason given for the majority view is that most international lending is to sovereign borrowers, their agencies and multinational corporations, or else is in the form of guaranteed trade credits. In the case of rescheduling by sovereign borrowers and their agencies, losses are mitigated by the penalty interest rates that most loan agreements incorporate for the contingency of rescheduling.

By contrast, recession and tight credit restraints in some industrialized countries could lead to more bankruptices and thus a relative increase in the ratio of domestic to international loan losses.

The minority of banks which think international loan losses may be greater than domestic losses over the next four to five years gave the main reasons as the possibility of further constraints on LDC access to Western markets for imports in the event of a protracted Western recession; and the possiblity of ever greater lending competition among banks leading to a greater proportion of relatively high-risk lending to LDCs. A Japanese bank made the point that although sovereign defaults or reschedulings might be fewer in number than domestic loan defaults, the amounts at stake to individual sovereign borrowers tended to be larger than to most domestic borrowers.

13. Turning to your bank's activities, do you anticipate a large increase in your international business? Specifically, do you anticipate that the ratio of the bank's international assets in total assets (on a world-wide consolidated basis) will increase or decrease in the course of the next two to three years (from end-1979)?

a. Increase of more than 20 per cent
b. Increase of 10-20 per cent
c. Increase of 0-10 per cent
d. Decrease of more than 20 per cent
e. Decrease of 10-20 per cent
f. Decrease of 0-10 per cent

14. What was your ratio of international to total assets?

- a. At end-1979?
- b. At end-1978?
- c. At end-1974?

The answers to Questions 13 and 14 are logically combined, but exclude a number of banks, like British overseas banks, to whom the questions are not applicable because their business is, by definition, wholly or almost entirely international.

Of the banks in the sample, about 25 per cent expect the ratio of their international to total assets to increase by more than 20 per cent in the three years to end-1982; about 35 per cent expect an increase of up to 20 per cent; and nearly all the others expect increases of up to 10 per cent.

Not surprisingly, banks whose international assets grew relatively fastest in the years to 1978 tend to expect somewhat slower growth in the coming years than those banks which lagged at an earlier stage. This is especially true of US banks, some of whose ratios are already above 50 per cent.

On the basis of the projections tabulated below, international assets will account for more than half of total assets by end-1982 also at three of the major non-American banks included and for more than a third of total assets at eight banks in the sample.

In all cases, respondents have answered the questions in terms of their total international lending operations and not medium-term lending alone.

Some banks in the sample stress that their aim is to increase their international lending in the coming years in the form of trade credits and lending to multinational companies, rather than to sovereign borrowers and their agencies.

Among US banks interviewed, two actually expected a decrease in the ratio of international business. However, the prevailing assumption among US banks is that the foreign market will continue to grow, but not as rapidly as in the 1970s, and the domestic market will expand more rapidly as new opportunities are opened by new technology and anticipated legislation. Banks have achieved their present proportions of domestic vs. international business not so much through grand strategy and setting of percentage targets, but primarily through seizing attractive opportunities for expansion; they are comfortable with those proportions now, and feel no need to set new targets. From their replies, one receives the broad impression that the era of rapid international expansion for large US banks has passed.

By contrast, bankers in Japan, whose proportion of international business is still relatively small, expect a large increase in their international business, providing it is permitted by official guidance. However, the authorities continue to regard bank lending and bond issues as "financing transactions" rather than "autonomous" from a balance-of-payments point of view. Such transactions would therefore continue to be subject to the authority of the Ministry of Finance and Bank of Japan, depending on the state of the balance of payments. So long as the current account is subject to wide swings, bankers expect the authorities' policy also to swing sharply from restraint to encouragement, even though most other capital transactions have been liberalized. This makes it almost impossible to develop long-term "strategic plans." The actual increase expected by most Japanese banks is between 10 and 20 per cent.

15. Do you anticipate that the ratio of international earnings to total net earnings will change appreciably over the next two to three years?

a. Appreciable increase
b. Appreciable decrease

Respondents' Answers
(per cent)

large increase	*moderate increase*	*little or none*	*other**
35	25	33	7

The answers to this question showed a clear distinction between banks according to their location. American banks, which are already heavily engaged internationally, expected little or no change in the ratio of their international earnings in the next two to three years. European and associated banks are approximately equally divided between those expecting large, moderate or hardly any increase in their ratios of international earnings. On the other hand, Japanese banks answering this question were almost unanimous in anticipating appreciable increases in their international earnings ratios. Liberalization of the foreign exchange law and confidence in the long-term strength of the yen were cited as factors by one Japanese bank. Another said it expected an increase in commissions from further increases of investments in Japanese securities by non-residents, increases in Samurai bond issues and increases in stock and bond issues made by Japanese companies in external markets.

As a generalization, banks expecting relatively large increases in international earnings in the coming two to three years are those whose international earnings have risen relatively slowly so far, while the opposite is true of those banks expecting only moderate increases or none.

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*Includes banks to which the questions are not applicable because their business is already fully international; banks that did not answer; and a small minority expecting a decrease.

In some cases, especially among European banks, expectations of a relatively faster growth of international earnings assume slow growth of domestic earnings.

16. In general terms, is there a maximum limit to the ratio of international to total assets which you would not like your bank to exceed, over the longer term? If so, could you indicate what the maximum would be?

Respondents' Answers
(per cent)

limits	*no limits*
57	43

In reality, the distinction between the policies of most international banks is not as sharp as may be suggested above. The main distinction is that no Japanese banks have set limits yet, "because our international assets are still relatively small," to quote one of them.

Other banks claiming to have no limits include one that says it is willing to increase its international assets to any extent that the business seems sound and some which say they have no static limits, but review their limits regularly.

In practice, the banks that claim to have limits seem to do much the same. The limits given vary between 25 and 66 per cent of total assets, but they all have in common that those limits are higher, by varying degrees, than the ratios of international assets to total assets at present. In some cases the limits presently set are very close to the ratio of international assets already achieved, such as 2 percentage points at one bank. In others, the limits suggest ambitious expansion — in an extreme case a bank has set itself a limit of no less than three times its present, not inconsiderable, international asset ratio!

As a generalization, however, banks that do not at present have limits are usually those with relatively small international asset ratios. An exception is a bank having no limit on the ratio of total international assets, but which limits its international medium-term commitments to 15 per cent of total assets.

17. The regulatory authorities in the United States have developed a system for drawing their banks' attention to credits which, in their opinion may carry undue risks and for generally supervising US banks' interna-

Ratios of International to Total Assets at 21 Leading European and Associated Banks

End of:																					
1974	12	34	10	33	3	60	36	30	10	15	21	4	50	8	10	8	31	∅	50	16	7
1979	25	38	10	33	10*	60	39*	50*	21*	15	28*	10	53	20	23	23	37*	20	41*	23*	14
Projected Change	b	c	b	c	a	c	b	b	a	0	c	c	c	a	a	0	c	a	c	a	c
Results	29	40	12	35	12	63	45	58	25	∅	30	11	56	25	28	23	40	25	43	28	15

Projected change reflects answers to Question 13 in which respondents estimate the change in the ratios of their international worldwide consolidated assets in relation to total worldwide consolidated assets from end-1979 to the end of 1981 or 1982 on the scales:

a) more than 20 per cent increase
b) 10/20 per cent increase
c) 0/10 per cent increase
d) more than 20 per cent decrease
e) 10/20 per cent decrease
f) 0/10 per cent decrease.

Results are an approximate indication of what the proportion of international to total assets would be at end of 1981 or 1982 on the basis of the banks' projections.

∅ = not available.

*Indicates banks whose foreign asset growth was arrested when expressed in the appreciating domestic currency of those banks (such as sterling based banks in 1978/79).

0 = zero change expected.

tional lending. Do you approve of their approach to bank supervision or not?

Respondents' Answers
(per cent)

approve	*disapprove*	*other*
29	44	27

A fairer breakdown than suggested above would be that nearly 80 per cent of the non-American banks in this sample disapprove of the American supervisory approach. The category "other" includes a number of non-American banks having branches or subsidiaries in the United States. Some of these declined to answer the question and others did so with an exquisite politeness which seemed to underscore, rather than disguise, their inherent disapproval (examples: "We always like to hear other people's opinions" and, "We have excellent relations with our State supervisors in the United States").

Respondents who flatly disapproved of the American system all made the same point: that it was not for the authorities to try to usurp the commercial judgment of banks, that the views of bank examiners should not be given greater weight than those of banks themselves and that excessive supervision of individual commitments might, indeed, impede the international banking system's efficiency.

On the other hand, a majority of these respondents approved of official supervision of banks' lending taken as a whole including informal discussions, as at the Bank of England, about some large or controversial lending decisions.

Unlike their foreign counterparts, American bankers mostly approved, or said that they approved of the US system of supervision. One respondent loyally "applauded" the efforts of US supervisors. That view was not, however, unanimous. Another American respondent said:

> "The regulatory authorities are not especially expert or perceptive in their country risk analysis. The list of problem countries that examiners use for reference is usually out of date. The examiners themselves can offer virtually no help in evaluating country risk. Our bank, and banks in general, are much more efficient at managing country risk than bank examiners."

18. (For banks with head offices outside the US.) In your opinion, will the system of bank supervision applied to your bank by your national supervisors have the effect of slowing down the rate of expansion of your international lending below the rate you would yourself consider prudent?

Respondents' Answers
(per cent)

yes	*no*	*n.a.*
25	63	12

Most banks which answered "yes" are Japanese. "The Ministry of Finance is very effective in slowing down our international expansion," said one.

The minority of other respondents which answered this question in the affirmative did so in the sense of expressing reservations about the influence of supervision on their international operations, rather than describing it as a severe constraint. For instance, a Dutch bank said that the prudential supervision exercised by its central bank on a worldwide, consolidated basis set standards no higher than the bank would set for itself, but it claimed that the standards set were higher than those in some other countries so that its international expansion was therefore more cautious than that of foreign competitors.

A British bank said that the new supervisory code being discussed with the Bank of England "may exercise some constraining influence over our rate of business expansion" but added, "we do not, however, see this as a serious problem."

A Swiss bank said that capital ratios and liquidity regulations "produce some restraint." And a German bank said that the proposed reform of German banking law which would apply capital and liquidity ratios on a worldwide, consolidated basis "may act as a brake." Bankers reported that in some other countries, such as Italy and Japan, the authorities are influenced by balance of payments rather than prudential considerations in their attitude towards banks' international business.

19. On the liabilities side, do you feel that greater uncertainty with regard to the stability of the deposit base (in terms of possible shifts in the geographical distribution or currency distribution of new deposits, for example) will act as a deterrent to new international lending?

Respondents' Answers
(per cent)

yes	*no*	*n.a.*
25	65	10

The large majority of respondents saying that they do not think excess concentration of their deposit base will inhibit new international lending nevertheless include some banks which are vaguely troubled by the phenomenon without as yet having worked out a clear policy response. "We are worried, but don't do anything about it" was a comment summing up the feeling of such banks. In a similar vein, another bank said it had "very reluctantly" accepted large OPEC deposits after the American freezing of Iranian assets in late 1979 because it would have been "embarrassing" to refuse the very important clients seeking to make those deposits. Most Japanese respondents answered "yes" or did not answer at all.

However, that still leaves a large majority of banks which say they are not unduly concerned about *geographical* deposit concentration for three main reasons. Firstly, the deposit base of major international banks remains highly diversified in spite of a proportional increase in deposits from some areas. Secondly, such banks reason that withdrawals by a single large depositor or even group of depositors must logically find their way back into the international interbank market for foreign currency (i.e. Eurocurrency) deposits, where the deprived banks, in the case of the largest, can bid back any funds needed on the finest terms. Thirdly, continuity of good relations is important for customers and not banks alone, so that an abrupt, generalized movement of funds seems likely only in exceptional circumstances (e.g. a temporary switching from smaller to bigger banks after Herstatt in 1974, a temporary channelling of new Iranian and some other dollar deposits to non-US banks after the Iranian siege of 1979).

Of somewhat greater concern than *geographical* deposit concentration for some banks answering this question has been a trend towards *shorter-term deposits* not confined to OPEC depositors alone, as a result of greater interest rate volatility and uncertainty. This has been particularly evident since October, 1979, when the Federal Reserve shifted to control of the US monetary base, thus allowing the price of money to be affected more quickly and sharply than before by changes in supply and demand. As already mentioned, this does not in itself influence the volume of deposits available to large international banks which dominate the international bank loan market. But to the extent that they cannot or do not match assets and liabilities in the case of three- or six-months medium-term rollover credits, their marginal cost of money may be increased or decreased and their returns may be affected correspondingly.

In addition, interest rate instability in the past two years has contributed to *currency switching* on the part of depositors; higher returns on some currencies and lower returns on others have not been offset by exchange rate changes in the latest period to the same extent as during most of the 1970s.

It is right to add, however, that most banks in the sample believe that these difficulties remain manageable, even though they have increased. By the same token, bank examiners in at least some countries report that they are concentrating more closely than before on the liabilities on bank balance sheets, especially in the case of relatively smaller banks that are nevertheless big enough to participate in international lending. (Prudential supervision of domestic operations has long concentrated on the deposit concentration of smaller banks).

Of the minority of banks that answered this question by saying they are actively concerned by excess geographical concentration of deposits, one said: "We worry about geographical concentration of liabilities, although not as much as about geographical concentration of assets." Another said, "We do not like to take funds from sources we would not like to lend to."

Only one bank reported putting absolute limits on its acceptance of liabilities from any single source, in most cases at 5 per cent of its total liabilities but in "exceptional" cases at 10 per cent.

Banks that limit their acceptance of liabilities in the case of individual international depositors or some classes of such depositors, whether rigidly as above or less so in most other cases, do so by two main ways. Some refuse by quoting returns which they believe will be unacceptable to prospective depositors. Others feel that it is less insulting and in the interest of continuing relationships to decline such deposits frankly by way of open but friendly discussion with the clients.

20. Would your bank consider offering facilities whereby deposit-liabilities would be denominated in a "basket of currencies," such as the SDR, as a means of offering a more stable asset to customers?

Respondents' Answers
(per cent)

yes	*no*	*n.a.*
75	18	7

Of the majority answering this question in the affirmative, more than a quarter already accept SDR deposits, some already issue certificates of deposit (CDs) denominated in SDR and a few already make some SDR loans.

However, nearly all respondents believe that the provision of SDR facilities by commercial and investment banks may have limited potential and that such business will almost certainly expand only gradually. One bank, which said it had been accepting SDR deposits for many years, even before the composition of the SDR was reduced from 16 currencies to five* at the beginning of 1981, reported that it had experienced "little appreciable growth" in client demand for such assets.

Several reasons were given for the almost unanimous view of slow and limited potential for SDR business:

1. The gradual start experienced by nearly all new markets until enough pioneers have entered it to encourage participation by a more cautious majority;
2. That banks and large non-bank participants already have sufficient alternatives for hedging currency exposure; multinational corporations and institutional investors like international pension funds and insurance companies traditionally match or should, in theory, try to match currency assets and liabilities;
3. Because the composition of the SDR has already been changed more than once, some banks believe depositors, or investors in SDR CDs, may have to be given the option of immediate redemption in the event of any further changes in the SDR's composition;
4. "The capacity of the forward foreign exchange market to cover positions arising from a large increase in SDR deposits has yet to be tested and could prove a serious constraint" — this from a bank that already accepts SDR deposits;
5. "We would be prepared to offer SDR denominated deposits only if we ourselves could invest on the same basis; otherwise we would be accepting considerable exchange risks on our assets".

In connection with this last point, some banks believe that issues of SDR assets to non-official investors by the IMF, envisaged as an experimental possibility, might help the evolution of this market.

21. What do you believe is the appropriate long-term relationship between the IMF and commercial banks with respect to information sharing, co-financing?

Nearly all banks agree that even more *sharing of information* with the Fund would be helpful. At the extreme, one bank accused the Fund of being "unnecessarily secretive."

Arguing the minority view, one bank said that greater information sharing might inhibit Fund members from supplying information. Against this, the case for the majority opinion was put by a bank which said that the Fund should do more to encourage member countries that sharing information with commercial banks is in the interests of the member countries themselves, and not in the interest of lenders alone.

A point widely ignored in answers is that reports made by Fund staff on member countries have circulated very widely among commercial and investment banks for many years; this is usually, but not in all cases, because member countries have chosen to make them available to banks.

---

* United States dollar, German deutschemark, Japanese yen, French franc and English pound, in that order.

The question of *co-financing* was assumed by respondents to suggest a somewhat more formal link than exists at present, when compliance with IMF conditions may be one factor encouraging the banking system to provide finance to a Fund member country. The kind of link suggested by the question was taken to be similar to the co-financings in which the presence of the World Bank encourages complementary participation of commercial lenders, but on their own judgment and terms; or the parallel investments in private enterprise made by the World Bank's affiliate, the International Finance Corporation, which is specifically designed to encourage the participation of commercial investors.

Nearly all respondents appeared to favor some degree of more formalized co-financing by the Fund and the international banking sector. However, all of them thought the potential for it is limited (as has proved the case with World Bank co-financings). Moreover, there was general agreement that any co-financing with the IMF should be on the same lines as with the World Bank, in which banks would remain responsible for exercising their own judgment and applying their own terms. "While there will be occasions when the interests of the Fund and the banks coincide, it is inevitable that the criteria of the two will often be different" was the comment of one bank.

Among the minority of banks opposing any more formalized link on principle was one which said the function of the IMF was to tide countries over balance-of-payments difficulties on the short- to medium-term by encouraging policy adjustments on the part of member countries. On the other hand, commercial lending, especially to higher income developing countries, has tended to concentrate on the financing of development designed to help borrowing countries increase their foreign exchange earning capacity over the longer term.

A special comment from an American bank was:

> "The appropriate channels for making IMF conclusions in written form available to commercial banks is via the central banks of the member countries and their executive directors at the Fund. This channel appears to be available to commercial banks in other major industrialized countries, but in the case of the US banks, neither the Federal Reserve nor the Treasury has been very cooperative in information-sharing which it might usefully involve written material."

Another revealing comment was that information from the IMF "is often slanted as though getting more information from the Fund would make you more receptive to lending. We would like to make the point that sometimes more information would make us less likely to lend."

22. Would you favor some easing in the conditions attached to IMF credits to encourage borrowers to go to the Fund at an earlier stage than has usually been the case in the past? Or would you, on the contrary, be very concerned at such a policy trend?

Respondents' Answers
(per cent)

in favor	*against*	*n.a.*
25	70	5

The case for the majority arguing against an easing of IMF conditions was put by a bank that said:

> "The Fund's conditions and policies have proved to be prudent and an easing of conditions attached to IMF credits could be the first step in an unwelcome direction. There are already several institutions dealing with hardship cases, like the International Development Association."

A second argument against an easing of IMF conditions is that such conditions, even in their present form, are no more than one factor influencing commercial bank lending to sovereign borrowers (see answers to Question 24).

Another argument, made by some banks in interviews, is that an easing of conditions would not necessarily and in itself encourage more members to approach the Fund at an earlier stage, because the timing of approaches to the Fund is often dictated by the political concerns of member countries rather than by the terms and conditions available from the Fund. There is a tendency for countries to resist going into the Fund in an attempt to demonstrate their viability to international lenders and their own electorates; by the same token a crisis approach to the Fund allows governments to shift responsibility for uncomfortable adjustment onto a distant agency in Washington. On such a view of relations between the Fund and some member countries, an easing of conditions might do little if anything to encourage earlier approaches, according to some bankers.

The minority view was put, hesitantly, by a bank which said it would favor some easing of Fund conditions, providing such relaxation is "not too great."

A more practical suggestion came from a bank which said borrowers might be encouraged to go to the Fund at an earlier stage "not by easing conditions, but by making it more attractive in terms of financial resources, like the recent changes in the guidelines for the use of the Fund's resources."

In this connection, another bank said, "The IMF has already done a great deal to increase the range and flexibility of its programs and this is insufficiently appreciated in the world at large."

An argument of several respondents was that the Fund might attain still greater flexibility less by an easing of conditions generally, than by an increasingly differentiated approach to the problems of individual member countries.

Respondents from the United States differed sharply on this question. Some felt the Fund ought to maintain rigorous conditions; a few others felt that world circumstances require an easing. On balance, it is clear that bankers view the ability of the Fund to impose policy conditions on borrowers as a mainstay of the system.

For firmness:

> "We would be concerned at an easing of standards. For a country with balance-of-payments problems, the crucial element is to adopt viable policies. Getting the policies right is the difficult part; financing is the easy part. We still believe that the key role for the IMF is in encouraging better policies, and the amount of lending it does is of secondary importance.
>
> "Where the IMF has taken a very lenient attitude, basically the country has dug itself deeper into the hole. But if there is a tough taskmaster, so that people know that if they get out of line they're going to face some real problems, that they are going to be disciplined, there will be fewer problems.
>
> Basically any actions that loosen conditionality act to our detriment as commercial banks."

There was some concern that the Fund had already in effect — if not intent — eased conditionality.

> "At any rate, last time in some cases it was felt that the oil facility had even slowed down adjustment in the sense that it made money too easily available. There were certain groups of the Fund staff that were opposed to duplicating that this time, because they would like to make sure that whatever lending the Fund did, it would keep the pressure on countries to get things under control and that that would be easier if you did it through the Fund's normal lending rather than through a special facility."

On the other hand, bankers recognized the advantages of persuading countries to go to the Fund at an early stage.

> "We feel that the IMF should play a more active role than they have done in the past, and that to the extent that a country needs assistance it is better to have their participation sooner rather than later. We do feel that the Fund has mellowed, and although there is this fear of conditionality — and to some extent you have to have it, otherwise the program isn't going to work — Fund involvement should be encouraged to be earlier."
>
> "One of the problems we had to work out was that the IMF does tend to be extremely rigid, and all of the things they are rigid on are proper and appropriate, right out of any good banking textbook. But if the rigidity is so rigid that a government is overthrown and you have a Communist or a Fascist government take over because it has been so rigid, then you may have got the textbook right, and the country just disappeared."

23. Do you think that the Fund itself would be able to borrow large amounts on the international financial markets and what, in your view, would be the best approach for the Fund to follow?

Respondents' Answers
(per cent)

yes	*no*	*n.a.*
87	11	2

The simplified breakdown above is yet one more that needs qualification. The minority short-handed as "noes" in this case consists of banks opposed to the concept of enlarged Fund borrowing from member countries and even more so from the markets, rather than banks which doubt the Fund's ability to borrow successfully if it so chooses.

The great majority believing that the Fund could and might, indeed, usefully borrow more from OPEC countries and other richer members, as well as from the markets, suggested a wide spectrum of possible assets that might be issued, from short-term paper to medium-term floating rate notes and at the other end, longer-term fixed interest securities, although several banks argued against the emergence of the IMF as a competitor of the World Bank in international bond markets.

Many banks expressed the view also that IMF assets denominated in SDR might prove widely acceptable and at the same time make an important contribution to the evolution of an international market in SDR assets.

Estimates of the amounts the IMF might raise from the markets, mainly the authorities of some member countries, banks and, marginally, from non-bank international institutions, ranged from "vast" (undefined) to $5 billion a year (unexplained).

A point made by several banks is that the IMF's sovereign immunity would need to be waived for market borrowing and (as in answers to Question 20) that investors might need the option of immediate redemption of outstanding SDR securities in the event of further changes in the composition of the SDR. Moreover, the IMF would need to help provide a sufficient market to give investors assurance of reasonable liquidity.

An argument against IMF market borrowing or borrowing from member countries at market-related terms was that this would push up the Fund's average cost of money and thus its lending rates, even though the Fund could expect to borrow on very fine terms.

The latter prospect, however, caused some bankers to question why OPEC and other member countries should wish to invest in IMF assets at returns below those safely available from the world's leading commercial banks.

The overwhelming view that the IMF could raise large sums if it wished was precisely the reason some bankers gave for opposing such an approach. "Any borrowing by the IMF would have a 'crowding out' effect and adversely affect the fund-raising ability of private lenders" was one comment. Another bank said the "danger" of large IMF market borrowing "could be a squeeze on banks' ability to fund their loan portfolios."

It was on such grounds, possibly more widely held than expressed, that one bank commented: "The very nature of resources [borrowed from the markets] does not seem quite appropriate to the Fund's requirements," a reference to the distinction between the roles of the Fund and the international banking system in the final section of the answers to Question 21.

Other comments included the following:

> "How would they do it? The Fund certainly faces a number of mechanical problems. Can they convince the investors that they are a good credit — other than the fact that this is the IMF, which although not a bank, has some kind of credit that will assure repayment?
>
> "When you get down to it you will find that although the US banks would do a lot of typical analytical work, many European banks would simply take the view that the IMF is virtually the agency of the governments of the world, and as such would take a positive view about its credit.
>
> "Many of them will regard the IMF in that way, that it is really the bank for the world and it would be in the interest of governments to see that it meets its obligations because if it doesn't we're going to have so many other problems to worry about this would be the least of them.
>
> "Now, we're not telling that to the IMF. We're telling the IMF that they should really write their prospectus and be very careful about presenting credit in the conventional way of looking at it."

24. When the Fund reaches an agreement with a member country on the adoption of an adjustment program, as part of a credit facility, would you regard this by itself as a decisive factor in your bank's decision to extend new credit to that country?

The answer to this question was unanimous and simple. It was summed up for all respondents by the bank which said that agreement between the Fund and a member country on the adoption of an adjustment program was regarded as "a positive but not decisive" influence on its own decisions to extend new credits to the country concerned. Among other factors taken into account by banks is the willingness and ability of a country to implement and persist in an adjustment program agreed with the Fund. Equally important is the distinction drawn by most bankers, and already referred to, between the Fund's role of tiding member countries over temporary difficulties, often by the dampening of domestic demand, and the role of market capital in contributing to development and the expansion of a borrowing country's net foreign exchange earning capacity over the longer term.

25. Other possible measures that have been suggested for easing the strain of recycling on the banks include the following:

The establishment of an international agency to provide insurance facilities for bank loans;
The establishment of an agency to provide official medium-term finance.

Do you favor either of these?

American reaction was sceptical towards the establishment of an international agency to provide insurance facilities for bank loans, or an agency to provide official medium-term finance.

On the insurance facility, one bank thought it might conceivably be useful in supporting a marginal enlargement of a loan in perhaps the $5 million range; but most rejected the idea as being too cumbersome, and raising sticky legal questions.

On the finance facility, the only even mildly positive response was that anything that could help ought to be looked into, so long as it did not "compromise the operation of free-market forces"; but most rejected the idea, saying existing agencies could meet financing needs.

Supplementary Question (for non-US banks)

How do banks assess sovereign and other international risk and how do they arrive at international lending limits?

Answers given in interviews brought out a clear distinction between the *subjective* assessment of sovereign and other cross-border risks and the *objective* limitations which banks place on their subjective analyses in the form of lending limits.

In the past decade, banks have devoted increasing time and care to country risk analysis. Such analysis concentrates not only on economic trends, but usually attempts some allowance for even more elusive factors like social and political stability. Yet, no matter how carefully structured, such analyses remain *subjective* in the last resort. And, because of that, they are only one factor influencing bank lending limits.

Many banks appear to translate their subjective judgments into *objective* lending limits by grading countries into classes or groups. Typical of this approach is the system of one major European bank which classifies foreign borrowers into five groups:

1. Governments and official agencies of the Group of Ten leading industrial countries, to which almost no lending limits are applied;
2. Governments and agencies of older industrialized countries outside the G-10 to which generous limits are allowed;
3. Oil exporting countries;
4. Newly industrialized countries (NICs);
5. High export-growth non-oil LDCs which have yet to be accorded the status of NICs in the international nomenclature.

Several points were made by banks using such systems of grading as the framework within which lending limits are set, both in the case of banks setting such limits in relation to their own capital and reserves, or as a proportion of their external assets or total assets:

- lending limits are not the same to all countries within a group; the limit applied to prime borrowers in one group may be close to that applying to lesser names in the group above;
- lending limits to individual countries, within the group parameters, are not static, but reviewed frequently to take account of borrowers' changing circumstances;

- the very act of providing additional credit may contribute to a perceived change in the borrower's circumstances, for better or worse;
- at some banks, limits are regarded as ceilings not to be exceeded in the absence of some change of circumstances appearing to make a higher limit desirable and prudent, but at other banks lending limits are set cautiously low to act as "trip wires" alerting the bank to a more careful assessment of the borrower's circumstances;
- exposure and lending limits are in all cases measured in terms of *gross* claims.

The inconclusive litigation cut short by the settlement of the dispute between the United States and Iran in January, 1981, simply underscored the great difficulty of banks, in the case of a dispute, trying to offset liabilities to an international borrower against claims on the borrower, even when the borrower's assets are within the jurisdiction of the bank's country of residence.

Statistical appendix and factual notes

(1)

WORLD DEFICITS, RESERVES AND MARKET FINANCING
(billions of dollars estimates)

	Non-OPEC deficits	Increase in world reserves	Total financing need	Market financing		Market financing as % of total need
				Gross	Net	
1977	42	56	98	100	66	67
1978	21	44	65	105	70	108
1979	75	39	114	115	75	66
1980	130	47	177	115	75	42
1981	105	. . .	. . .	125	. . .	. . .

Sources: IMF, OECD. Current deficits include transfers; world reserves, excluding gold, include OPEC members'; gross market financing includes international bonds and publicized Eurocredits; net financing estimated at about 66 per cent of gross financing. 1981 forecasts by OECD. 1978 data distorted because most OPEC members were also in deficit that year; 1980 figures affected by reserve draw-down by many deficit countries. Average market financing for the years 1977-80 was 70 per cent.

Source: *The Banker*, London, June, 1981.

(2)

MAJOR BANKS' CAPITAL/ASSETS RATIOS

	1970	1980
Average 4 US banks	5.01	3.79
Average 4 UK banks	7.63	5.98
Average 3 German banks	4.26	2.90

The banks are Bank of America, Citicorp, Chase and Morgan; Barclays, National Westminster, Midland and Lloyds; Deutsche Bank, *Commerzbank* and the Dresdner Bank. Source: *The Banker, London.*

(3)

To help put the subjective views of respondent bankers into perspective, the following factual notes are appended to the answers to Question 1:

Real interest rates on new loan commitments to non-oil LDCs fell from a positive 5 per cent to a negative 15 per cent between 1972 and 1974 and remained negative until 1977, from which point they rose gradually to about 2 to 2½ per cent at mid-1980. Real rates are defined as nominal rates less the three-year change in borrowing countries' export prices (New York Federal Reserve Bank Quarterly Bulletin, Spring, 1981).

The same source, using World Bank, IMF and the New York Fed's own estimates, suggested that the ratio of debt service to export earnings had risen only from about 8 to 11 per cent for all non-oil LDCs between 1974 and 1979, but that it had doubled to 24 per cent for "major borrowers," namely Argentina, Brazil, Chile, Colombia, Mexico, Peru, the Philippines, South Korea, Taiwan and Thailand. Among the latter, however, the debt service ratio rose during the five years to 1979 from about 15 to about 38 per cent for "low export growth" countries (Argentina, Brazil, Mexico, Peru and the Philippines), but only from about 8 to 10 per cent for "high export growth" countries (Chile, Colombia, South Korea, Taiwan and Thailand).

The IMF World Economic Outlook of May, 1980, put the ratio of external debt to exports of goods and services of net oil-importing LDCs at 69 per cent in 1980 against 67 per cent in 1973, but the ratio of external debt of those countries to gdp rose from 13.5 to 17.3 per cent during the period.

Mr. Jacques de Larosiere, Managing Director of the IMF, has estimated that loans to non-oil LDCs remained approximately unchanged at about 17 per cent of the gross external assets of the Western banking system between 1970 and 1979.

(4)

GLOBAL CURRENT PAYMENTS
(billions of dollars)

	1975	1976	1977	1978	1979	1980	1981	1982
Current balance								
OECD	0	−18	−24	10	−35	−77	−63	−45
OPEC	27	36	29	4	66	121	109	67
Non-oil developing countries	−30	−17	−12	−23	−39	−53	−61	−62
Other non-OECD countries	−18	−13	−8	−9	−4	2	0	−3
Total*	−20	−12	−16	−18	−13	−7	−15	−43

Source: OECD Economic Outlook, July, 1981.

* reflects errors and asymmetries.

(5)

Although terms for borrowers eased steadily on the international bank loan market from 1976, the volume of new publicized Eurocredits rose from less than $30 billion in that year to $80 billion in 1979, whereafter it stabilized. The easing of terms to borrowers may have helped slow down the willingness of some banks to enter new commitments. However, other factors can be cited too. Many countries took advantage of favorable terms for precautionary borrowing through 1979 and were thus able to ride out 1980 by running down reserves and drawing on undisbursed credits. Another factor that may have helped check the expansion of new publicized Eurocredit borrowing after 1979 was a return of real interest rates to levels not experienced since 1972. Narrowing lending margins for banks and high real interest costs for borrowers may have combined to produce the "unusually large share of short-term international lending" during the second half of 1980, reported by the Bank for International Settlements in July, 1981. Maturities of up to one year accounted for two-thirds of the growth in Western banks' external claims during the second half of 1980 compared with 40 per cent during the preceding 12 months. During the second half of 1980, 62 per cent of new international lending to Latin America was "short-term", meaning up to one year, and the proportion to Asian borrowers other than Japan was 77 per cent. "This development reflects the lesser role played during 1980 by the syndicated loan market as a source of credit to the developing countries" said the BIS.[*]

[*] *Source:* Maturity distribution of international bank lending, Bank for International Settlements, July, 1981.

(6)

LDC BORROWERS ON INTERNATIONAL BOND MARKETS
(billions of dollars)

	1976	1977	1978	1979	1980	1981[*]
OPEC	0.1	0.8	1.5	0.4	0.5	0.1
Non-OPEC	1.5	2.8	2.7	2.7	1.9	0.5
Total LDCs	1.6	3.6	4.2	3.1	2.4	0.6
Total Int'l Bonds[+]	32.5	32.2	34.3	41.0	41.9	9.6
			per cent of new issues			
OPEC	0.4	2.5	4.5	1.0	1.3	1.2
Non-OPEC	4.5	8.5	7.8	6.5	4.6	5.4
Total LDCs	4.9	11.0	12.3	7.5	5.9	6.6

Source: Morgan Guaranty, World Financial Markets; figures rounded.
[*] First quarter. [+] Foreign plus Eurobonds.

PUBLICIZED EUROCREDITS TO LDCs
(billions of dollars)

	1976	1977	1978	1979	1980	1981*
OPEC	4.0	7.4	10.6	12.7	11.5	1.9
Non-OPEC	11.0	13.4	26.7	35.2	23.5	6.7
Total LDCs	15.0	20.8	37.3	47.9	35.0	8.6

International bonds as per cent of bonds plus credits to LDCs

	1976	1977	1978	1979	1980	1981*
OPEC	2	10	12	3	4	5
Non-OPEC	12	17	9	7	7	7
Total LDCs	10	15	10	9	6	7

Source: Morgan Guaranty, World Financial Markets; figures rounded.
*First quarter. +Foreign plus Eurobonds.

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Two World Trade Center
Suite 9630
New York, New York 10048
Tel: (212) 775-9160

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Robert V. Roosa is a partner in the private banking firm of Brown Brothers Harriman. Before joining his present firm in 1965, he was four years Undersecretary of the Treasury for Monetary Affairs and preceding that was with the Federal Reserve Bank of New York for 15 years. He received his doctorate in economics from the University of Michigan.

The Multiple Reserve Currency System*

Robert V. Roosa

The emergence of floating exchange rates in the early 1970's, which proponents had long foreseen as eliminating the need for a reserve currency, has instead by the early 1980's created a virtual constellation of reserve currencies. The U.S. dollar is still at the center of the system. But orbiting around it now are two secondary reserve currencies, the Deutschemark and the yen, and three tertiaries, the Swiss franc, the pound sterling, and the French franc.[1] Not all of this is new. The roles of the pound and the French franc have simply decreased in emphasis and magnitude over the past decade. The others have been drawn into use alongside them as ancillary reserve currencies because the world's brief experience with totally "free" floating from March to June 1973 demonstrated that there was still a need for reserve assets in the system.

A spreading divergence of prices, output, trade, and capital flows among growing countries had by 1973 impelled the break-up of that system of exchange rate parities hinged to the dollar, which had for a quarter century provided a reassuring climate of stability for world trade and capital movements. After 1973 central banks needed multiple options among the assets held in their reserves in order to parallel in some degree the patterns of varying use among currencies that had already been developed by the private traders and investors of the world. The problem, as those alternative currency options have become increasingly available, is to find some approximation or substitute for the conditions of comparative stability in exchange rates that had supported the unprecedented gains of the world economy from the late 1940's to the early 1970's.

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* Although the writer has full responsibility for all views and data in this paper, it has benefited from extensive discussions within a Reserve Currency Study Group chaired by Johannes Witteveen; from data developed by Roger Kubarych, Boris Antl, and Peter Seeley; from criticisms of previous drafts by Geoffrey Bell, Peter Kenen, Jacques Polak, Michiya Matsukawa, Robert Pringle, and others; and from the all-round assistance of William Reichert.

[1] The ECU, first issued to the members of the European Monetary System in 1979, is not included since the assets "behind" the ECU are U.S. dollars and gold contributed by the members from their existing reserves, supplemented occasionally by holdings of the currencies of members that arise from swaps arranged for intervention purposes.

In part, this seeking for stability on the part of national authorities and their central banks has been expressed through various approaches to managed exchange rates. The issues and obstacles in that effort are the subject of many other studies, including several by the Group of Thirty, and will not explicitly be examined further here. In part, too, the quest for stability has fostered creation of the European Monetary System (EMS), by members of the European Economic Community (EEC), with a "parity grid" maintained among the central rates of the participating countries. That is the subject of a brief paper by Dr. Rieke of the Bundesbank that is appended to this volume. In addition, while the SDR may be visualized by some as an eventual replacement for national currencies in serving the reserve asset function, any large scale shift in that direction may have to await much wider use of the SDR in the trading-payments transactions of the world at large.

The focus in this discussion will be on the implications of the increased use of other national currencies as reserve assets clustered around the dollar — implications both for the currencies and countries that are the object of this confidence, and for the functioning of the system as a whole. These implications will have to be seen in the context of the great enlargement and diversification of the extra-territorial markets that have developed in all of the reserve currencies, both the old and the new, outside the direct reach of their central banks. Moreover, some reference is also relevant to the potentialities of the IMF action taken in 1980 to redefine the SDR, reducing its "composition" from what had been sixteen currencies to include by a nice coincidence only those five currencies in the new reserve currency constellation which are also members of the Fund (i.e., excluding the Swiss franc).[2]

Three of the succeeding papers in this volume have been prepared by current or recent officials associated with the newer reserve currencies — the Deutschemark, yen, and Swiss franc. They present in greater detail the direct experience which each currency has undergone in the new setting. A fourth paper outlines a reverse pattern, that of "winding down" the reserve role of sterling. This introductory paper will, in addition to summarizing briefly what has happened to the overall size and composition of reserve assets, outline some system-wide aspects of what has happened thus far, and identify some broad questions for which answers will still have to be sought in the future.

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[2] The selection was actually made on the basis that these are the currencies of the five countries within the Fund which have the largest exports of goods and services; their reserve status was not an explicit criterion.

1. The Growth of Multiple Reserve Currencies

A national currency does not become a reserve currency through a simple act of will by the monetary authorities of the country involved; indeed the Swiss, German, and Japanese authorities have resisted, even thwarted, such developments for years as the central banks or financial institutions of other countries tried to acquire holdings of Swiss francs, or Deutschemarks or yen. The originating force has come from the world marketplace. But until the monetary authorities of the three newest reserve currency countries began to acquiesce to the market's advances, reserve accumulations in these currencies were a very small part of the world total.

Once begun, the scale accelerated rather quickly. Total foreign exchange holdings in the reserve assets (i.e., excluding gold and SDRs[3]) reported to the IMF by its members, by any of several measures[4], nearly tripled from the end of 1973 to the end of 1980, stimulated dramatically by the accumulation of OPEC surpluses. Over that same period, while the size of reserve holdings of dollars continued to increase, the proportion of dollars in total official holdings of national currencies (excluding gold and SDRs) shrank from 85 percent to 75 percent. Sterling's share was halved, from about 6 percent to 3 percent. The French franc remained about 1 percent. The newer reserve currencies rose: the Deutschemark, from under 7 percent to 13 percent; the yen, from zero to almost 4 percent; and the Swiss franc, from under 2 percent to about 4 percent. Meanwhile, of course, SDRs had also entered the reserve system and by the end of 1980 member holdings of SDRs were about 4 percent of the total non gold holdings included in reserve assets.

The growing totals and changing composition of reserve assets held in foreign exchange have been in part propelled by the growth of the extraterritorial markets for currencies. While primarily serving the payments and credit needs of the banking and trading sectors of the world economy, these markets (perhaps most conveniently subsumed under the one heading "Euro-markets") have also attracted many central banks.

One measure of the uses made of these markets for ordinary commercial and financial purposes is provided by various estimates of banking claims in the Euro-markets. These figures, as would be expected, now dwarf the scale of all central bank reserve assets in those same currencies by a factor of about three-to-one, even allowing for much double counting. Interestingly, the private sector seems to have led the central banks in diversifying out of dollars. At the end of 1973 the dollar accounted for about three-quarters of all holdings in banks in the Euro-markets — holdings that then represented a somewhat smaller total than the aggregates of all domestic assets or liabilities in the domestic banking systems of those same currencies. By the end of 1980, the dollar's share had shrunk closer to two-thirds of these now immense Euro-markets; the Deutschemark had become nearly one-sixth; and the Swiss franc accounted for slightly less than half of a remainder that included yen, sterling, French francs, and Dutch guilders.

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[3] At the end of 1980, total reserves reported by the IMF were SDR 755 billion, of which 57 per cent was in gold (valued at the current market price), 4 per cent in SDR and IMF drawing rights, and the remaining 39 per cent in national reserve currencies.

[4] The complexities, risks of double counting, reporting inaccuracies, and other hazards encountered in tabulating total reserves are described in various notes accompanying the more detailed tables in succeeding papers. Generalizations here are limited to approximate magnitudes and directional movements.

Central banks, though understandably trailing far behind in diversifying out of dollars, were not all content to keep their diversified holdings of reserve assets located within each of the reserve currency countries. The Euro-market holdings of central banks, reported by the Bank for International Settlements (BIS), have also been increasing rapidly (more rapidly in other currencies than in dollars, although the dollar was still about two-thirds of total official holdings in the Euro-market at the end of 1980). As a proportion of total official holdings in dollars, Euro-dollars were about one-third at the end of 1980, while the proportion of Euro-Swiss francs in the total of central bank foreign exchange reserves held in that currency was about four-fifths; for the Deutschemark, about half; for sterling, one-fifth; for yen, one-tenth; and there were no appreciable reserve holdings in French francs outside France. Moreover, since the reserve centers themselves keep virtually all of their reserve holdings in official balances with each other[5], and since their holdings of dollars are still very large, the distribution of holdings by non-reserve central banks is more widely diversified than these proportions would imply.

2. The Purposes and Functions of Foreign Currencies as Reserves

Although currencies acquire official reserve status only when they are held by other central banks, they approach that role by becoming more widely used in the trading-payments activities of the commercial world. Sterling and the French franc became reserve currencies when London and Paris were the centers of large empires, in which trade was largely conducted in the "mother currency," and countries outside found it convenient also to trade in such widely used currencies. As those originally dominant positions declined, the center of currency gravity shifted toward the currency of the strongest economy with the greatest trading potential, the dollar. And it has been the resurgence of the German and Japanese economies since World War II, while the great growth of the entire world economy was diminishing the relative predominance of the American economy, that has created the need for the Deutschemark and yen as additional trading-payments currencies. The Swiss franc, of course, although not representing an equally powerful economy, has combined the servicing of highly specialized domestic industry with unique facilities for providing financial security to investors outside Switzerland.

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[5] The United States does not generally, however, hold significant amounts of any of the other currencies; its internatonal reserves are still largely in gold, but also include IMF drawing rights and SDRs

In effect, the world has become too big and complex to have its trans-national payments needs met almost exclusively by one currency, even if U.S. policies had been impeccably reassuring to confidence. The consequences, when variations in the paces and prices of other countries made it impractical for them to keep pegging their currencies to the dollar, have been wide and frequent fluctuations in their exchange rates against the dollar. The traders and bankers of the world have, therefore, had to diversify the currencies they use; and their central banks have followed in the currencies they hold as reserves. The risks had become too great in relying on only one currency as a store of value or for settling balance of payments drains or gains; various combinations of central bank currency holdings have been the result.

The outcome has not, however, been the development of a full array of equally usable reserve assets. The other currencies are, in scale of holdings or in versatility of uses, likely to remain in secondary or tertiary roles for some time to come because they are unlikely to match the dollar as a transactions currency any time soon. As several of the later articles point out, a fully adequate international reserve asset should be a medium of exchange, a standard of value, and a store of value — not only for other central banks, but also for the traders and bankers of the world.

The dollar, of course, in some degree serves all three purposes for both classes of holders, that is, for the commercial-financial world and for central banks. All of the other currencies serve as a medium of exchange, in the sense that the markets and other central banks use them in foreign exchange trading, but usually (outside the EEC) the trading in other currencies is against dollars rather than against each other. As standards of value, the reserve asset currencies are used more in the invoicing of exports from the home country than in imports; but as Dr. Matsukawa outlines so clearly for Japan, none of the new reserve currencies are widely used in invoicing among third countries. As stores of value, however, all are increasingly used as part of the diversification process, both in the private markets and by central banks; but such holdings are, of course, highly susceptible to interest rate spreads, to shifts in confidence, and to changing exchange rates. It is indeed in this last respect that a multiple reserve currency system, in a world of flexible exchange rates, not only amplifies the potentialities for instability, but perhaps paradoxically may also offer opportunities for a stabilizing equilibrium.[6]

3. Is a Multiple Reserve System Stable?

Conceptually, as foreseen in academic analyses confined to the movement of goods in trade, a system of floating exchange rates would be expected to produce an equilibrium of reasonable stability among all currencies, which should be readily interchangeable at freely determined market rates of exchange without any need to use one or more reserve assets as a common frame of reference. In practice, partly because of those same wide differences in price, production, and trade behavior among countries that made floating inevitable, since the early 1970's there have been remarkable exchange rate swings of 15 to 50 percent over relatively short periods, even among currencies of the most developed countries. "Overshooting" and "bandwagon effects" have become common parlance in the exchange markets.

Out of this experience come two key questions: (A) has the emergence of a variety of reserve currencies, which the very existence of floating helped to induce, created a built-in aggravation of the volatility already associated with flexible exchange rates, which may have a dampening effect on world trade? and (B) will frequent shifts into or out of a given reserve currency, either by the commerical world or by other central banks, create new obstacles to the desired management of a country's domestic monetary policy, possibly leading to greater economic instability? And beyond these lies another question: (C) will the existence of several different reserve assets permit or encourage a larger volume of reserves overall, perhaps resulting in excess liquidity creation for the world as a whole, and greater worldwide inflation? The record thus far does not provide a clear answer to any of these questions, but it does suggest a presumption that will need testing over a longer period.

A. Exchange Rate Volatility of the New Reserve Currencies

As to volatility, all three of the new reserve currencies have shown wider fluctuations than the non-reserve currencies over the period since central bank holdings of each currency began a decisive rise. For the Deutschemark, the sharp rise in reserve holdings began near the end of 1975; for the Swiss franc, the end of 1976; and for the yen, the end of 1977. All three currencies were on a rising exchange rate trend against the dollar in the initial stages of the surge in their use as reserves. Each has (along with sterling) experienced cumulative upward swings, since the inception of large holdings as reserves, in magnitudes of 50 percent against the dollar, with correspondingly steep declines. Except for the Dutch guilder, linked closely to the Deutschemark, no other major currency has experienced oscillations as large.

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[6] The SDR remains of limited use as a reserve asset because it has not yet found a way to enter the foreign exchange markets. It is, however, being increasingly used both as a standard and as a store of value.

For short periods, there has also been a noticeable increase in volatility, although the contrast with other currencies is less pronounced. In terms of standard deviations of change against the dollar on a monthly basis, the Deutschemark did not show much change until 1978; but the volatility of the Swiss franc and the yen shot upward quite clearly as their use as reserves accelerated. This shorter term volatility did not appear, moreover, to be linked to short term changes in domestic interest rate fluctuations in any of the three countries, since interest rate volatility did not change appreciably while the exchange rate volatility was rising.[7]

If there should be continuing evidence of greater volatility among the newer reserve currencies, the crucial question, of course, is whether or how this matters — either for the reserve currency countries themselves or for the more general growth of world trade and payments. The record is too short — and too much intermingled with such extraordinary economic events as the remarkable rise of U.S. interest rates and the dollar in 1980 and 1981 — to permit more than gratuitous inference. The fact that gross intervention through the sale or purchase of these reserve currencies by their central banks approached an equivalent of $100 billion from 1976 through 1980 suggests, however, some interest in dampening fluctuations in the exchange rates of reserve currencies — fluctuations which presumably would have been even larger without the intervention. Whether or not there has been a related constraint on the expansion of world trade cannot as yet be determined. It is suggestive, however, though no doubt related to many other adverse developments, that the real volume of world trade reported by the IMF (including estimates for non-members) rose at annual rates of only 4.6 percent from the end of 1976 to the end of 1980, while it had grown at average annual rates of 8.5 percent from 1962 to 1972, and at 5.9 percent from 1972 through 1976.

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[7] Had there been a closer correspondence with domestic interest rate fluctuations, or with spreads between those interest rates and comparable rates in the United States, there would have been a stronger presumption that the exchange rate volatility resulted simply from the action of the private market — in contrast with the inference here that a currency's reserve asset role (and the prestige thereby associated with its more widespread use) contributed a special impulse toward its exchange rate volatility.

The introduction of the EMS and its ECU in 1979 is also suggestive evidence that constraint on the fluctuation of other EEC currencies against the Deutschemark is considered important as a stimulus to trade within the European Community. The analogy is limited, though, since the EEC countries actually negotiate their central rates with each other, making changes in response to shifts in the overall economic relations among themselves. The comparison with any intervention undertaken by other central banks, and outside the EEC context, is only relevant to the extent that the intervention by EEC countries in the exchange markets serves to minimize fluctuations that do not signal a need for explicit changes in the central rates. It would, of course, be futile and wasteful for other central banks to attempt through currency market intervention to establish exchange rates which their underlying economic conditions would not support. However, the withdrawal of the United States itself from active intervention, after its short-lived initiative from November 1978 until early 1981, may open the exchange markets in the other reserve currencies to more volatility, with its uncertain consequences, over the period ahead.

B. Reserve Currency Repercussions on Domestic Monetary Management

During the quarter century of the dollar's hegemony, envious criticisms were often pointed toward the presumed advantage which the dollar's role gave the United States — that is, an "automatic" financing of deficits without discipline. Whether or not that criticism may have been valid at times, there seems little likelihood that the same concept could be extended to the new reserve currencies. The simple fact that there are several reserve currencies clearly exposes each reserve currency to the continuous risk that other central banks will shift holdings among them. That is emphasized by the fact that a dominant aspect of the reserve currency role of each, at least thus far, is to serve as an investment currency, and that shifts by central banks or others can occur through the Euromarket even when domestic capital markets are narrow, or underdeveloped.

The consequent exposure to the critical surveillance of other central banks offers far less potential for sustained financing of deficits through increased distribution of a particular reserve currency than any scope which might once have been afforded the United States. For during the dollar's quarter century, the only options for other central banks were to shift into sterling or French francs — opportunities not often taken — or to acquire gold, an option that was increasingly constrained by their reluctance to drain away U.S. gold stocks. (Although tacit United States resistance to gold sales became stronger in the later 1960's, its gold holdings were nonetheless reduced by more than one-half from 1950 to 1970.)

Whatever degree of "immunity" may have been available to the United States for financing external deficits, the most likely exposure of the new reserve currencies is of a quite different nature. Because of the persistent instabilities that influence interest rates and exchange rates, there will frequently be situations in which business-financial holders of currencies will be shifting from one reserve currency to another -- in order to improve yields, seek an exchange gain, or minimize risk. Whether or not such shifts are also made on any sizable scale by central banks, any one of the new reserve currencies must expect from time to time to be the recipient from the market of substantial inflows, or the object of outflows, of cash balances or investment funds. It cannot plan indefinitely on retaining increased amounts of foreign holdings as reserve financing of its deficits.

Whenever inflows go directly into the domestic economy, they tend not only initially to raise the exchange rate of the receiving country, thereby penalizing its exporters, but the result will also be to enlarge the reserve base available to its domestic banking system. If conditions do not call for expansion of domestic money and credit, the central bank may have to try to absorb the increased domestic bank reserves or otherwise attempt to sterilize the inflows, through domestic market operations or swaps with its banks. That conceivably may also tend to raise domestic interest rates, perhaps attracting even more funds from abroad, and repeating the pattern. Whether or not such action may coincide with a current account deficit (or surplus) of the affected country may be quite accidental.

The position may be clearly perverse if the flow into a reserve currency occurs only in the Euro-market. If a currently unwanted strengthening of that currency's exchange rate should then be countered through offsetting sales by the central bank of its own currency in that market, directly or through swaps with its banks, the result must almost inevitably be to add to holdings of dollars in its own reserves (because the dollar is nearly always the currency of convenience on the other side of such sales). The central bank may then face a need to sterilize those reserves domestically.

The opposite situation may be equally disturbing, when holders, whether central banks or in the private market, move out of a reserve currency. When the outflows come from domestically lodged funds, for example, there is an immediate drain on the internal reserve base. If that drain and the resulting decline in the exchange rate occurs because of general outside concern over the particular country's performance, the implied discipline may be appropriate. But holders can decide to move for so many other reasons, including the sheer speculation that another reserve currency appears likely to offer exchange (and/or interest rate) gains, that the local monetary authorities may find themselves impelled to take offsetting action against withdrawals, through further deliberate tightening of money and credit, and the inducing of higher interest rates, even at a time when the economy is sluggish or declining and instead needs domestic central bank support.

There are many other possible scenarios, both in the home economy and the Euro-market. The common element, however, is that countries whose currencies serve as international reserve assets acquire an added dimension of exposure, beyond that associated with the currency movements which accompany the goods and capital flows of other countries. Not only may this mean wider fluctuations in the exchange rates of the reserve currency countries, but also the reserve flows themselves may at times be so volatile, and so disruptive for the home economy, as to force the affected central banks to accept wider (or perverse) swings in interest rates or the money supply contrary to the aims of their domestic policies. A case study of the ways in which reserve currency status has in the past aggravated domestic problems and inhibited domestic economic management for sterling is presented in the paper by Deputy Governor McMahon. The more recent experience of the Swiss National Bank, as described by President Leutwiler and Dr. Kästli suggests that whatever the cause, or source or destination of the inflows or outflows, the added attractiveness of reserve currencies seems to create added complications for the execution of domestic monetary policy.

C. The Inflation Potential of a Multiple Reserve System

The apprehension that a multiple reserve system would be prone to excess liquidity creation, leading to persistent inflationary pressures across the world, has been prompted by two concerns. One is that since an excess of world reserves seems to have been created by the United States when its overall balance of payments was in deficit, the risks of such excesses may be compounded when several countries are in a position to finance external deficits through international money creation. A second concern is that, without implying abuse of their role by any of the reserve currency countries, the routine operation of the system may produce reserves and currency (at home and in the Euro-markets) that expand on an aggregate scale determined by the world's nominal (rather than real) "needs of trade." The 19th century British debate between the currency and the banking schools, as to the circularity of this kind of process, may in this new context reappear with worldwide relevance. That is, in a multiple reserve system there is no overall "governor" to set limits on what may otherwise add up to very large and potentially inflationary aggregate reserves and currencies for the world as a whole. The system may become as loose as some domestic economies have been before becoming subject to the overall constraint of a central bank.

As to the first concern, the existence of alternative reserve currencies may create a virtual automatic check on any tendency for one reserve currency country to depend upon the acceptability of its currency by others as a means of financing its own balance of payments deficits. Central bank holders of any reserve currency now have a ready opportunity, if the economy supporting that currency begins a profligate course, to shift to another reserve currency. There is no doubt that the officials of the central banks in the new reserve asset countries are already aware of the pressures that may be created through outflows from their currencies, just as they are also conscious of the difficulties for domestic monetary management that may be created by enlarged inflows.

The second concern is that the "natural" growth of reserves (including holdings in the Euro-market) may in the aggregate become excessive, and promote a vicious circle of inflation — i.e., higher prices lead to higher commercial needs, which lead to larger uses of credit and related money creation, and these in turn lead on to higher reserves. So stated, this concern becomes another version of the "engine of inflation" problem, pointing to the perennial question as to how large the world's reserves should be, how rapidly they should grow, and under what kind of overall limitation. It was uneasiness over the growth of dollar reserves, and the processes through which they were created, that caused the IMF to propose the SDR as an alternative. As yet, of course, SDR creation has not become a significant factor influencing the total of world reserves and liquidity.

There may indeed be some interaction between this process and the unprecedented growth of worldwide inflation since the early 1970's. The oil financing problem in particular generated large and unanticipated demands for credit, much of which was financed through new money in the Euro-market. Although that flexibility has avoided, thus far, the crisis that once seemed threatening, it may also symbolize a potential problem of an excessive (through quite unintended) generation of money and reserves through a multiple reserve system in the future. Admittedly, both the central banks and the commercial-financial participants in the Euro-market have until now considered any overall controls impractical and unnecessary. And while there is no conclusive evidence of danger yet, the possibility does deserve continued surveillance.[8] Any corrective action, if and when appropriate, will surely require a close collaboration among the reserve currency countries and the IMF to determine what kinds of joint action can most effectively be taken.

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[8] For example, a study group of the Group of Thirty, chaired by John Heimann and Geoffrey Bell, is examining the broad issue of international banking risks.

4. The Prospects for a Stable Equilibrium

The readiness with which currency holdings may be shifted from one reserve asset currency to another, while it may serve to check tendencies toward an undue expansion of liquidity in individual reserve currency countries, also does expose each reserve currency to more sizable inflows and outflows than would occur if it played a much less prominent role within the system. Because there is always a possibility that events will cause holders to wish to converge on one or two currencies, while withdrawing from the others, there is an inherent risk of wide fluctuations, possibly of violent instability. As experience grows with the existing constellation of reserve countries, increasing attention will probably be given to ways of minimizing large disturbances among the reserve currencies. While it would be too much to hope for stability comparable to that of a constellation in the firmament of outer space, the aim presumably must be for a kind of relative stability among the reserve currencies.

There are at least three ways in which some approach to reducing instability might be developed: (A) coordinated intervention in the currency markets; (B) closer harmonization in economic policies and performances among the reserve currency countries; and (C) expanded responsibility by the IMF for the five reserve currencies now represented in the valuation of the SDR.

A. Coordinated Intervention

While intervention alone can rarely if ever be sufficiently powerful to determine and maintain an exchange rate, intervention techniques have already demonstrated a capacity to moderate those extreme swings which may carry a rate well beyond any reasonable zone of sustainable viability. All five of the other reserve currencies have, since 1961, participated in the "ring of swaps" initiated by the United States. During the first decade, these facilities were used extensively in the effort to defend and maintain fixed rates of exchange. Once floating became inevitable, that earlier experience provided a very useful base from which to cope with aberrations in the new system. A body of understanding has begun to develop concerning the degree to which swap lines can suitably be used to help check extreme swings, in conditions where there would be general recognition among the authorities involved that a currency was "overshooting."

The development of an underlying body of understanding among all the reserve countries has, of course, much further to go. Any incipient consensus is susceptible to periodic interruptions such as that most recently announced by the United States, but even the U.S. position of virtually total withdrawal initiated in March 1981 has begun within a few months to be relaxed as the new Administration participated further in the kinds of international consultation in which the leading countries have come regularly to engage concerning their balance of payments positions and their interest in currency intervention. Perhaps it is not impossible to foresee the development, over time, of a sharing of analysis and expertise in ways that will produce very tentative ideas as to ranges or "target zones" for the matrix of exchange rate relations among the six reserve currencies — or at least among the dollar, the Deutschemark, and the yen. Such consultation might lead to clearer recognition of ways in which conflicting tendencies in the basic economic policies and performances of these countries could be in some degree ameliorated. Possibilities of this kind would at least seem to merit continual evaluation, in light of the susceptibility to volatility that seems inherent in the multiple reserve system.

B. Approaches to Harmonization among Economic Policies and Performances

Of necessity, there will always be differences among nations in their economic and social objectives, as well as in their resource availabilities for meeting them. This means that it would be quixotic to hope for actual coordination of economic action among all of the reserve currency countries. Even fulfillment of the objectives set for the European Economic Community — a more nearly homogeneous group of countries — seems remotely distant. Yet it is important for the reserve currency countries to continue working toward common understanding of each other's goals and capabilities. Although beginnings have been made within the OECD, for example, and through the various summit meetings among national leaders, no sustained focusing on such objectives has yet been achieved. As the reserve currency countries come more and more to experience the vulnerabilities which they jointly share, however, the impetus toward greater harmonization among their economic policies as they interact upon each other will surely become stronger.

Short of coordination, even to aim for programs only of collaboration, if attempted on a comprehensive basis, would no doubt prove counterproductive. But there is more promising scope in singling out from time to time those particular issues of common national interest on which a closer degree of harmonization of action might be achievable. Clearly the overriding significance of energy has already made it a centerpiece for the kind of consultation, and for some limited degree of cooperation, that should be the aim of the reserve currency countries. Time may show that the emergence of a multiple reserve system has created a stimulus toward actions that can lessen economic oscillations in and among the key countries in the non-Communist world.

C. Expanding the Involvement of the IMF

Through its consultation procedures and its continuing analysis of the economic performance of its individual members, the IMF is in a position to contribute toward improving both the uses of market intervention and the efforts for harmonizing economic policies among the reserve currency countries — although it has not as yet shown a readiness to do so. Within the structure of its own operations, in addition to its consultations, the IMF also has interesting potentials. For example, to the extent that a central bank has conducted intervention by drawing upon swap lines, only to discover that it has been incorrect in expecting an early reversal of exchange rates that would permit retirement of the swaps, drawings of the Fund can provide a useful means, alongside direct borrowing arrangements among the reserve currency countries, to carry any imbalances that continue for a somewhat longer period than originally foreseen.

At some stage, too, the IMF might (perhaps should) develop a capability for closer surveillance and advice on some of the mutual questions which the reserve countries face in determining guidelines and procedures for intervention in the foreign exchange markets. That would be a logical furtherance of the Fund's new Article IV, which gave it the task of maintaining firm surveillance over the exchange rate policies of its members.

There may also be a broader role for IMF participation in, or encouragement of, various kinds of contingency planning. Those could well center on arrangements designed to buttress the financial strength or help lessen the instability of one or more of the reserve currencies in the face of cataclysmic events, including the possibility of everything from natural calamities to military action to speculative panics. Such arrangements would be a simple extrapolation from the concepts that underlay the organization of the Group of Ten in 1961. The Fund should also quite naturally be drawn to a special relationship with the reserve currency countries because all of its own liabilities are stated in SDRs, which in a very meaningful sense are related to the prospects for the countries whose currencies determine the value of the SDR.

The Fund also is best placed to keep close watch on the possibilities that might lead the multiple reserve currency system to become a stimulus to inflation — either as an individual currency might over-expand, or as the system as a whole might generate a spiral of liquidity creation in response to the "needs of trade." Both in signaling incipient problems, and in convening countries to develop effective responses, the IMF can, and in time should, take a strong initiative. Moreover, the leverage of its own drawing rights could be used to help support corrective action, if such action should be found necessary.

If the Fund should have as an objective that of diagnosing and proposing actions for lessening instability among the reserve currency countries themselves, it would surely thereby also strengthen prospects for reasonably steady growth by all members of the IMF. That may mean at times that the Fund could serve as an arbiter or intermediator, helping to resolve some of the kinds of differences that inevitably arise among the reserve currency countries. Beyond that, the Fund might be asked to take a special responsibility for restraining or assisting any one of the five reserve currency countries if, in the broader judgment and interest of the others, some independent action or counsel is needed.

Looking even further down the road, thought should be given to the possibility that at some stage the world could again return to the comparative stability of a single reserve asset, with that asset being the SDR. A very early and limited step in that direction might be taken through redesigning an implementation of the Substitution Account, perhaps for all of the reserve currencies. In these various ways, and no doubt in many others, the emergence of the new multiple reserve asset system has clearly added, at least potentially, both to the responsibility and the opportunity for the IMF to exercise an effective role in the guidance of the world economy.

The Development of the Deutschemark as a Reserve Currency

Wolfgang Rieke

1. The Factors Leading to the Deutschemark's Emergence

The emergence of the Deutschemark as the second most prominent reserve currency owes much to the same factors that years earlier led to the predominant role played by the dollar (and sterling) as an international currency; but there are also some distinguishing features which deserve mention. Among the *common features* are

- the perennial German current account surplus (up to 1978) and the Deutschemark's soundly based strength in the exchange markets;
- the liberal trade and payments regime in force over many years;
- the steady expansion of Deutschemark denominated assets held by private non-resident investors;
- the growth of indebtedness denominated in Deutschemark by both private and official foreign borrowers (due in large degree to the openness of the German capital market except for short periods, as well as the existence of a free Euro-Mark-market).

Among the *distinguishing features* are

- the relatively minor role — compared with the dollar and even sterling — played by the Deutschemark as a transactions currency in world trade and payments (excepting German foreign trade, of which a substantial share is denominated and settled in Deutschemarks);
- the lack of a suitable range of instruments for the placement of liquid funds in domestic financial markets;
- the long-standing official preoccupation with the undesirable implications of short-term capital inflows for monetary policy (mainly to the

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Wolfgang Rieke is presently the chief of the International Monetary Affairs Department at the Deutsche Bundesbank. Before joining the Bank in 1966, Dr. Rieke had held positions at the IMF in Washington and the OEEC in Paris. He received his degrees in economics from the Universities of Hamburg and Kiel.

German corporate sector, but in recent years increasingly also to the domestic banks, though the latter tended generally towards a maturity range beyond four years);

- the related official resistance against the Deutschemark assuming a reserve currency role through various measures prohibiting the sale of short-term financial assets to non-residents, including monetary authorities.

While the "common features" have clearly favored the Deutschemark's emerging role as a reserve currency, the "distinguishing features" have probably tended to discourage, and somewhat delay, that role at least to some degree. However, excessive dollar creation and American "benign neglect" of the dollar as a store of value for private and official dollar holders have increasingly rendered such obstacles ineffective, or encouraged their circumvention by various routes, especially that offered by the Euro-markets.

Even in the recent phase of a sharp swing from current account surplus into deficit and the consequent weakening of the Deutschemark's exchange rate the Deutschemark's reserve currency role was left unimpaired. Statistical evidence firmly supports this view at least for 1980. For 1981, when the German balance of payments situation began to improve again, no firm conclusions are possible. The Deutschemark's greater underlying stability (in terms of relative inflation rates) was reasonably maintained despite strongly adverse terms-of-trade effects; at the same time there continue to be uncertainties about the dollar's prospects (and those of other potential or actual reserve currencies). While official Deutschemark holdings declined in some cases, large reserve accruals to major OPEC surplus countries continued to favor diversification, and the mark has remained at least a partial "beneficiary". In addition, there was a renewed strong inflow of private capital into Germany on a gross basis while the expansion of the external Deutschemark markets slowed down.[1]

2. A First Stage

In a first stage of the emerging reserve role of the Deutschemark the interplay of the various "features" mentioned above and other factors encouraged diversion of the official demand for liquid mark investments to the Euro-market. The very nature of the Euro-market as an international money market made it responsive to new demands as they arose. Viewed from the side of the investors, the desire for anonymity has been of particular importance, given the critical attitude of German authorities towards an enlarged reserve role of the mark, but also for other reasons.

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[1] For statistical evidence relating to the above and other themes developed in this article, see Appendix, pages 56-73.

The reasons why the German authorities have always looked upon the Euro-market with considerable reservations are far ranging. They relate to the potential of the Euro-market to be a source of uncontrolled liquidity creation, world inflation and exchange market instability; its weakening effect on the discipline of balance of payments adjustment; and its lack of adequate banking supervision, etc. The Euro-Mark-market was also seen as an alternative source of credit for German borrowers in periods of restrictive domestic monetary policy (depending on relative interest rates and other factors).

Paradoxically, it was at the same time felt that as long as the Deutschemark's international role developed "outside national borders", any potential negative repercussions for domestic monetary policy would be kept to a minimum. It can be argued that this attitude has in turn contributed to the rapid expansion of the Euro-Mark-market and has facilitated the mark's growing reserve currency role outside the area of national influence. But it may also be asked whether greater tolerance of the Deutschemark's reserve role via domestic channels would have effectively forestalled these developments or secured greater control for the national monetary authorities.

As far as the possible consequences for exchange rates (of the build-up of Deutschemark denominated official reserve claims in the Euro-market as compared to domestic asset holdings) are concerned, the Bundesbank stated in its Monthly Report for November 1979: "Whereas investments of foreign funds in the domestic financial markets, being capital imports, directly affect the German balance of payments and thus tend to push up the exchange rate of the mark, *investments of Deutschemark outside Germany* have no immediate impact on the balance of payments; nevertheless, such transactions, too, may influence the exchange rate of the Deutschemark."

Concern about the possible undesirable repercussions of a build-up of non-resident holdings of domestic mark assets for domestic monetary conditions and policies was always based in large part on the limited capacity of German money and capital markets (compared with those in New York and London), and the dangers of greater volatility in these markets affecting domestic liquidity and interest rates which the central bank might find difficult to offset.

3. A Second Stage

In a second stage, international demand for Deutschemark reserves was also accommodated — in addition to the ongoing build-up of Euro-mark reserve claims — to some extent by "asset swaps" involving the acquisition of additional dollar claims by German investors, including the central bank, and the sale of Deutschemark claims to non-residents. The Bundesbank, in particular, could be seen on occasion as operating a unilateral or national "substitution account" for dollars. We are here mainly talking about the period of floating exchange rates during the 1970's, which (as is now realized) coincided with the period of most rapid growth in total international reserves (quite contrary to widespread expectations). During these years the share of the dollar in total official exchange reserves remained roughly unchanged, so that on the surface the growing share of the Deutschemark seemed more like a shift away from reserves held in sterling, rather than diversification out of the dollar. However, if the dollar holdings of the Bundesbank itself, and of other major reserve holders, whose currencies are increasingly held as reserve currencies, are excluded there has been a significant decline in the share of exchange reserves held in dollars.

The change in the net external position of the Bundesbank (and of its dollar holdings, in particular) is no adequate measure of its role as a "substitution account" for other countries' dollar reserves. For instance, over the three years 1976 to 1978 — following the first oil shock — a cumulative current account surplus of 38 billion DM was recorded; over the same period the Bundesbank's net external assets (excluding SDR allocations and valuation changes) rose by 39 billion DM. The bulk of the simultaneous increase in official foreign Deutschemark assets held in Germany by about 13 billion DM can be seen to have as a counterpart long-term capital outflows from Germany of some 17 billion DM. This would suggest a role as "banker of the world" for Germany similar to that sometimes attributed to the United States. However, assuming long-term capital outflows of a certain size as a "natural" counterpart of the current account surplus expected of a highly industrialized country, some part of the reserve accrual to the Bundesbank may be taken to represent substitution of dollars through the Bundesbank.

Over these three years, the Deutschemark/dollar exchange rate rose by roughly 40 percent, which indicates that the Bundesbank did by no means readily accommodate foreign demand for mark assets, and that those assets were in fact only to be had "at a price". This is confirmed by the strong rise of official Deutschemark reserve holdings in the Euro-mark-market, estimated at about 10 billion DM over the same period.

4. A Third Stage

In a third stage starting in 1979, Deutschemark claims are being acquired in the process of financing the newly emerged payments deficits. In 1979 and 1980 taken together, Germany incurred a current account deficit of 39 billion DM, while gross capital outflows (including errors and omissions) amounted to no less than 92 billion DM. This total new gross "supply of Deutschemark" through the balance of payments of 131 billion DM had its counterpart (one-fourth) in a 33 billion DM reduction of the Bundesbank's reserves, and for the balance of 98 billion DM in a variety of short and long-term capital inflows, including substantial medium-term official borrowing in OPEC countries. In 1980 alone, the Bundesbank's reserve loss was 28 billion DM, almost exactly matching the record 30 billion DM current account deficit, (and thus the economy's dissaving). But with long-term private capital outflows substantially exceeding "normal" levels, a sizable gap remained to be financed through an increase in Deutschemark liabilities, including to official monetary authorities abroad.

The increase in foreign official reserves held in domestic mark assets for the same period has been estimated by the IMF at around 22 billion DM, the additions mainly occurring in periods of Deutschemark weakness in the foreign exchange market (especially in 1980 in the first quarter and again in the second half of the year). This includes about 8 billion DM resulting from intervention in the mark/dollar market by the Federal Reserve Bank of New York and to be used, in part at least, towards the redemption of Carter notes and bonds with Deutschemark denomination (and therefore to be treated as a special category). A considerable part of the OPEC investments for the benefit of the German public sector amounting to more than 12 billion DM does not seem to be included in the total figure of the increase in official reserves as identified by the IMF.

In 1981 the current account was still in large deficit (between 20 and 25 billion DM), though on a declining trend since the second quarter of the year. Especially compared with 1980, capital imports (excluding special official borrowing) were again more than adequate towards financing the current account deficit plus capital exports, though official borrowing also continued on a substantial scale. Net external assets of the Bundesbank increased again moderately.

On balance, the Bundesbank's inclination is not to rely unduly on the potential reserve currency role of the Deutschemark towards the financing of balance of payments deficits, for a number of reasons. As suggested earlier, and confirmed by the experience with other reserve currencies, prolonged periods of deficit especially on current account tend to call into question the policies pursued in that country and with it, the attractiveness of a currency to be held as a reserve asset by other countries. It is true, of course, that due to the special character of the current account surpluses of the OPEC countries the situation may in many respects differ today from that of earlier periods. In the case of major OPEC countries these surpluses serve the express purpose, at least to a considerable extent, to permit accumulation of financial claims bearing an adequate rate of return, to be drawn on in future. To the extent that liquidity is a relevant factor for OPEC countries' investment policy, provision of attractive reserve claims by deficit countries would seem to satisfy their needs, at least as long as all major potential reserve currency countries are in deficit at the same time.

However, this is not the case even at present; in fact, the United States and the United Kingdom are in surplus. Even in the case of Germany, to rely on the "quasi-automatic" financing of very large current account deficits, through the provision of reserve type assets on a continuing basis would open up the spectre of an excess of the supply relative to the demand for Deutschemark assets. Over time, the problems related to a "mark overhang" then could well be on the table.

It may be relevant here to recall that during past years of large current surplus and continuing reserve gains in dollars, Germany found itself in the position of a country faced with difficult choices regarding its reserve policy. True enough, the decision taken to "float" the mark against the dollar, initially in May 1971 on a temporary basis (pending the Smithsonian re-alignment of exchange rates), and then more permanently as of March 1973, was primarily taken to limit the domestic monetary consequences of excessive accruals of dollars to the reserves. But considerations relating to the quality of the dollar as a store of value also were of some relevance over the years.

Undue reliance on quasi-automatic reserve liability financing of large current account deficits even in current special circumstances raises other questions as well. Even if surplus countries investing reserves in the Deutschemark could be counted on to hold on to their reserve holdings and to add to them, other holders, private and official, of liquid mark funds would not necessarily do so, especially if the exchange rate showed signs of weakening due to the size of the current deficit, or other factors. Recent experience indicates that for major currencies — dollar, sterling on the surplus side, the mark on the deficit side — prospects for its future performance (expectations) are an important factor weighing on the exchange rate. This is likely to be very relevant also with regard to the question of inherent "stability" or "instability" of a multiple currency reserve system and to the likelihood of such a system adding a new dimension of anti-inflationary discipline to the balance of payments adjustment process.

5. Conclusion

This three-stage approach to the process by which the Deutschemark has evolved into its current role is not without its pitfalls. Prior to 1973 the statistical data available are very sketchy and incomplete. To some extent the rapid development of the mark as the second most important international reserve and investment currency since the early 70s may therefore be just a reflection of the growing improvement of statistical transparency.

Even after 1973, considerable gaps, inconsistencies, and uncertainties about the analytical relevance of certain data remain. The most important one since 1978/79 is the growing discrepancy between Euro-currency holdings in marks and above all U.S. dollars as identified by the IMF in its creditor statistics and by the BIS in its debtor statistics. There is also a growing volume of foreign assets held by monetary authorities and, if kept in the Euro-currency markets, identified by liable Eurobanks as such, which are not reported as foreign exchange reserves in the strict sense (including holdings of Eurobonds and of similar assets) and for which only very approximate estimates can be made.

Also, the significance of any overall share figure for a currency like the Deutschemark is greatly impaired by the fact that there are vast differences between holders. For instance, at the end of 1980 the overall share of official Deutschemark reserves of all countries amounted to about 12½ per cent. Excluding the dollar holdings of the Bundesbank the share was nearly 14% (calculation strictly on the basis of IMF data and excluding the value of ECUs issued against gold in the denominator). Exclusive of an undistributed residual of reserve holdings the same calculations arrive at percentages of 13% and 14½%, respectively. However, the shares of most industrial countries were much lower and those of oil-exporting countries and non-oil LDCs substantially above average. According to earlier calculations of the IMF, the Deutschemark share for the group of SDR and other basket peggers had reached in late 1978 already about 25 per cent of their total official foreign exchange holdings.

Another consideration is that the three stages identified above cannot be strictly separated in terms of time sequence. For example, when the second stage of "asset swaps" started in 1974/75, the accumulation of official Deutschemark reserves in the Euro-market by no means ceased. The bulk of additional Euro-holdings was still to come. Similarly, the third stage starting in early 1979 only means the advent of an additional factor, and not necessarily the end of a further build-up via the first and second avenues.

Finally, it should be underlined that the three-stage approach cannot be adopted "in isolation"; it must be seen in the context of the development of other reserve currencies, viz. the relative decline of the importance of sterling and the U.S. dollar. As already mentioned, the ascendance of the Deutschemark in the 70s until the end of 1976 was largely a switch between sterling and the Deutschemark in the number two position following the diversification move by official sterling holders of former sterling area countries nearly "à tout prix". Similarly further demand for Deutschemark assets quasi-automatically arose when the dollar, as the pivot of the international monetary system, came under pressure in the foreign exchange markets in 1977 to 1979 following the advent of a U.S. current account deficit and signs of overextension. At the same time any further increase in the role of the mark may be narrowly circumscribed by the role of the dollar which continues to have all the attributes of the leading reserve currency, whereas the Deutschemark is largely used only as an investment currency, and less so for transaction and intervention purposes.

The Yen — A Newly-Emerging Reserve Currency

Michiya Matsukawa

Until 1974 the yen played no significant role either as a settlement currency in international trade or as a reserve currency in official reserves, though it was used to a small extent in the Far East as a local currency, mainly by Japan's trading partners. Only in late 1975 was the yen first listed by the IMF as one of the major currencies used in international reserves (in a table in that year's annual report) and its share in total official reserve assets was put at only 0.6 percent.

However, in the following years the yen emerged rapidly as one of the world's reserve currencies. This process was facilitated by Japan's impressive recovery from the economic crisis caused by the first oil shock and the increasing weight of the Japanese economy in the world economy: from 1975 to 1979 Japan's share in the aggregate GNP of OECD countries rose from 12.5 percent to 15.0 percent.

There was also an evolution in official policy. After 1975 the Japanese authorities assumed a more accommodating stance on the long-discussed issue of the internationalization of the yen, and gradually relaxed controls on foreign exchange transactions. As a result, the yen was traded more actively on foreign exchange markets. For instance, the share of the yen in the total volume of foreign exchange traded on the New York market rose from 5.3 percent to 10.2 percent between April 1977 and March 1980.

By 1979, the yen had become widely used as a reserve currency, its share rising to 3.6 percent (excluding ECU holdings in the definition of

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Michiya Matsukawa presently serves as Senior Adviser to the President of Nikko Securities, and was formerly Special Advisor to the Minister of Finance, Japan. Previously, he was Vice Minister of Finance for International Affairs.

world reserves) at the end of 1979. It is, indeed, the third most widely used reserve currency, after the dollar and Deutschemark.

The process through which it became a major international currency can be analyzed by reference to the evolution of Japan's balance of payments.

1. Balance of Payments, 1975 — 1980

In 1975 and 1976, Japan's current account balance roughly coincided with the magnitude of changes in its official reserves; i.e. the deficit in the current account in 1975 was almost as large as the fall in the reserves and the current account surplus in 1976 was very close to the increase in reserves. In both years the net capital outflow remained relatively small and happened to correspond to an increase in the overseas liabilities of the banking sector.

In 1977 and 1978, when the current surplus grew rapidly, official reserves also increased, but much of the surplus was directed towards financing increased capital outflows. In 1978, in particular, the outflow of capital was accelerated further by a rise in the liabilities of the banking sector, a trend that continued in following years.

Indeed, the outflow of capital maintained its momentum even when the current account dived into the red as a result of the second oil shock in 1979. The unprecendented size of the deficits on both current and capital account could not be financed only by drawing on the reserves: the liabilities

TABLE 1

Balance of Payments of Japan
(in million dollars)

	1975	1976	1977	1978	1979	1980
Current Account	−682	3,680	10,918	16,534	−8,754	−10,746
Current Account	−1,410	−873	−3,832	−10,851	−10,241	5,465
Long-Term Capital	−272	−984	−3,184	−12,389	−12,618	2,934
Short-term Capital	−1,138	111	−648	1,538	2,377	3,071
Change in the Official Foreign Reserves	−703	3,789	6,244	10,171	−12,692	4,905
Yen Rate to 1 Dollar at year end	305.15	293.00	240.00	195.10	239.90	203.60

Note: The difference between the current account and capital account total and the change in the foreign reserves is composed of (1) monetary or banking transactions and (2) errors and omissions, of which the latter is relatively smaller than the former.

of the banking sector had to be increased by an inflow from abroad, some which was on official account.

The same was the case in 1980, when the current deficit remained large. True, there was a dramatic turnaround on capital account, which contributed to an upsurge in Japan's official reserves, but the banking sector continued as in previous years to increase its liabilities to overseas private and official holders.

2. Yen Holdings by Non-residents

The principal ways in which non-residents acquire yen are as follows[1]:

1. By converting foreign currency into yen and depositing it with the banks;
2. By buying yen-denominated assets;
3. By investing in Japanese equity shares;
4. By investing in yen-denominated long-term bonds and securities.

The increase in the amount of various types of yen assets held by non-residents during the past ten years is illustrated in the accompanying tables. The Japanese authorities did not resist this rapid increase; given the existing international monetary and economic situation, they regarded the process of the internationalization of the yen as inevitable and thus maintained a rather accommodating attitude towards it. As the precedent set by the Deutschemark in the previous 15 years had shown, the currency of a strongly-expanding economy invevitably becomes an international currency. As is well known, the Japanese economy has expanded year after year. Strong confidence in its future naturally caused a rapid increase in the demand for yen in the international money and capital markets. This phenomenon was seen both 'in the case of the pound sterling in the nineteenth century and the dollar after the second world war.

Apart from the attraction of the superior performance of Japan's economy, other factors also have encouraged investment in yen-denominated assets:

(1) As the international money system is based on the floating rate system at present, and at the same time, a huge amount of money

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[1] The simplest way is for non-residents to acquire yen cash or its alternatives (like traveler's checks denominated in yen). This is popular among tourists and others who expect to use yen for their payments or remittances at the time.

The amount of yen cash or its alternatives purchased and held by non-residents is not considered to be so large as to constitute an important part of this study. However, recently the total amount of yen cash which is taken out of Japan by Japanese tourists may add up to a sizable amount. One way to estimate it is to follow the reflow of cash back to Japan, as yen cash which is taken out by tourists and spent at souvenir shops overseas is sent back to Japan, and falls under the category of "invisible trade" in the balance of payments statistics. The total reflow amount of yen cash thus estimated seems to be around one billion dollars per annum but the size of total outstanding yen cash outside of Japan is hard to estimate.

is in the hands of a limited number of asset holders, specifically the oil exporting countries, good management of large monetary assets becomes a matter of great concern for their holders. They are more and more interested in diversifying their investments in order to avoid possible exchange risks. Thus in the process of diversification, yen-denominated assets become very attractive as a part of their investments.

(2) Among the major currencies, the yen has experienced particularly extreme swings in its value. This record has attracted short-term investors, not the least being the speculators of "hot money".

(3) When Japan fell into deficit on current account, Japanese banking institutions were encouraged by the authorities to go overseas for financing rather than to rely upon sales of foreign exchange by the Japanese authorities. This movement provided a good chance for non-resident investors to obtain yen-denominated assets.

TABLE 2

Outstanding Amount of Non-Residents' Claims
Yen Deposits, Japanese Securities and Euro-Yen

(in billions of dollars)

End of	Yen Deposit[1]	Japanese Securities[2]	Euro-Yen[3]
1970	0.5	2.7	n.a.
1971	0.9	5.0	n.a.
1972	0.9	7.4	n.a.
1973	0.6	5.2	n.a.
1974	0.9	3.9	n.a.
1975	1.5	6.3	n.a.
1976	1.8	12.6	n.a.
1977	3.2	14.1	3
1978	7.2	23.1	8
1979	4.4	30.7	14
1980	10.1	42.6	17

[1] Source: Bank of Japan. There is some overlapping with "Euro Yen" which is estimated around a couple of billion dollars as of the end of 1980.

[2] Source: Bank of Japan. This item covers foreign investments in Japanese notes, securities and equity stocks expressed in yen. These investments, however, include securities issued by Japanese entities in foreign markets in their currencies. Around 80% of the figures in this column may represent investment in yen-denominated securities.

[3] Estimates.

Note: All figures are converted into U.S. dollars at the exchange rate obtaining as of the end of the year.

TABLE 3

Issues of Yen Bonds for Non-Resident Borrowers

	Yen Bonds* Floated in Japan		Yen Bonds Floated in Euro-market	
	(billions of yen)	(billions of dollars)	(billions of yen)	(billions of dollars)
1975	20	(0.1)	-	
1976	65	(0.2)	-	
1977	326	(1.4)	30	(0.1)
1978	827	(4.2)	15	(0.1)
1979	400	(1.7)	25	(0.1)
1980	261	(1.3)	55	(0.3)

Note: Figures in parentheses are the billion dollar equivalents calculated by the Yen-Dollar rate as of the end of the year.

* The amount purchased by non-residents is not available. The share of subscription outside of Japan varies in each case but it may not be misleading to assume that around a quarter of the total amount of this column was sold outside of Japan.

TABLE 4

Outstanding Amount of Overseas Claims and Liabilities of Japan

(in billions of dollars)

	1975	1976	1977	1978	1979	1980
Claims:	58	68	80	118	135	167
Long-term	32	37	42	63	83	95
Short-term	26	31	38	55	52	72
Official	*13*	*17*	*23*	*33*	*21*	*26*
Banking	*13*	*14*	*14*	*21*	*30*	*45*
Others	*0.2*	*0.2*	*0.3*	*0.6*	*1*	*1*
Liabilities:	51	58	58	82	106	150
Long-term	14	18	20	29	36	49
Short-term	37	40	38	53	70	101
Official	*1*	*2*	*2*	*5*	*6*	*7*
Banking	*26*	*28*	*27*	*37*	*50*	*78*
Others	*10*	*10*	*9*	*11*	*14*	*16*
Balance	7	10	22	36	29	17

Source: (1975 — 1979) Ministry of Finance (1980) Estimate

All figures include both yen denominated and foreign currency-denominated amounts.

(4) Since the early summer of 1980, many fund managers outside of Japan, especially those who are interested in long-term investments, have found their yen-denominated assets safer and more attractive than alternatives when they took into account the continuously outstanding performance of the Japanese economy and the political and sociological environment, which is essentially stable and trouble-free.

(5) In connection with the "recycling" of the oil money, Japanese financial institutions have predominantly used the Euromarkets (or "zeno-markets") to finance their lending in third countries. The main purpose of this type of transaction is doubtless to avoid possible exchange risks in the years to come and these transactions have no direct effects upon holdings of yen-denominated assets. However, closer and deeper relationship between the Japanese financial market and the zeno-markets will help indirectly to accelerate the process of the internationalization of the yen.

3. Yen for International Settlement

Though the yen has become popular among non-residents, it is used mainly for the purpose of storing value rather than for settling international tradings.

In Japan's international trade and service contracts, the currency most often used is the U.S. dollar; the yen still plays only a minor role, though its share is increasing very slowly. In more concrete terms;

(1) In 1975, 78.5 percent of export contracts [2] was denominated in and settled with U.S. dollars; only 17.0 percent was in yen. In 1980, the dollar share in export contracts decreased to 66.3 percent while the yen share increased to 28.9 percent.

(2) In 1975, 88.9 percent of the import contracts[3] was denominated in and settled with U.S. dollars and only 0.9 percent was in yen. In the third quarter of 1980, when the latest statistical data became available, the dollar share of import contracts increased to 93.0 percent and that of the yen increased slightly to 2.3 percent reflecting a sharp decline of the British pound share.

The Ministry of International Trade and Industry announced on May 19, 1981, new statistics on monthly exports and imports which contain a currency breakdown of export contracts. For the month of April, the first month of fiscal year 1981, the currency breakdown is as shown in Table 5. The new statistics are calculated on the basis of the *number* of contracts rather than the *amount* involved. Therefore, the yen share thus calculated will only roughly correspond with its share calculated in terms of the currency amount of the contracts involved.

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[2] Calculated on the basis of Letters of Credit. Accordingly, they do not include the contracts under the intergovernmental economic cooperation agreements and those of plant construction, etc., which are accompanied with credits.

[3] Calculated on the basis of Import Licenses.

TABLE 5

Currency Breakdown of Export Contracts
For the Month of April, 1981

	$	Yen	Others
All Commodities	61.3	32.8	6.0
Foodstuff	82.6	15.0	2.4
Textiles	81.3	15.8	2.8
Chemical Products	79.3	13.6	7.1
Non-metal Mineral Products	55.2	41.2	3.5
Metal Products	82.5	15.2	2.3
(Iron and Steel)	(92.6)	(6.1)	(1.3)
Machinery	49.1	43.7	7.2
(Motors)	(48.0)	(47.5)	(4.5)
(Television Sets)	(55.8)	(31.0)	(13.1)
(Tape Recorders)	(39.2)	(47.1)	(13.6)
(Automobiles)	(50.7)	(43.7)	(5.6)
(Ships)	(42.2)	(55.2)	(2.6)
(Heavy Electric Machinery)	(51.7)	(41.7)	(6.6)
Others	61.2	30.9	7.9

5. Concluding Remarks

It is extremely difficult to figure out the precise amount of Japanese yen now held by non-residents because the realities of the overall international financial system are complicated and the available information is limited.

Nevertheless it may be safe to estimate that the total amount of yen held by non-residents was equal to 25 billion dollars at the end of 1979 and that it increased during 1980 by about 30 billion dollars, partly due to the appreciation of the yen vis-a-vis the dollar. Thus, at the beginning of 1981 the total amount of yen held by non-residents was presumably equal to about 55 billion dollars.

Regardless of the minor turmoils in the foreign exchange market in 1981 the yen has been traded without either strong upward or downward pressures. Between the monetary markets of Tokyo and New York, there has been a large interest differential in recent months, which is depressing the exchange rate of the yen against the U.S dollar. The interest differential between Japan and the United States affects the flow of short-term capital but has not had a strong effect on the continuous inflow of long-term capital into Japan. In other words, the yen's trend has not changed much in the sense that the yen is still very attractive as a vehicle for storing value and is moving closer to becoming a major reserve currency.

In its function as a settlement vehicle in international financial transactions, the role of the yen is still much less than that of the other currencies of major industrialized countries. The currency which is used in international contracts is determined by both parties of the contract, who at present are not interested in using the Japanese yen as their settlement currency. In this respect the yen is still at the stage of being an "incomplete reserve currency" or "secondary reserve currency" and by no means fully functions as a reserve currency like the U.S. dollar.

The history of the Japanese yen as an international currency is still very short and its emergence in the international financial markets has been relatively fast. Consequently it is difficult to foresee in what manner and by what magnitude the yen will be internationalized in the near future. The monetary authorities of Japan maintain a very cautious attitude. They fear that they may lose reasonable control over the monetary aggregates of the yen and also that effective countermeasures in the case of a foreign exchange crisis may be weakened.

It may be worthwhile to conclude this study by quoting some concluding remarks from a speech made last year by Mr. Shijuro Ogata, of the Bank of Japan[4];

> "We feel that the gradually wider use of the Japanese yen in international transactions is inevitable. . . .
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> "While it is not possible to stop such evolutionary processes in the markets, we are not always or not necessarily happy with the larger holding of yen balances by non-residents, because such a development will make domestic monetary control more complicated and more difficult. . . .
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> "The internationalization of the Japanese yen is not the target we should aim at, but rather the natural outcome of the development of our economy as well as the financial markets, or the inevitable price for such development.."

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[4] Speech by Mr. Shijuro Ogata, Executive Director, The Bank of Japan, to a group of foreign bankers made on April 8, 1981 in Tokyo.

The Swiss Franc in a Multiple Reserve Currency System

Fritz Leutwiler and René Kästli

1. Introduction

Since the beginning of the 1970s the role of the US dollar as an international reserve currency has gradually decreased. The newly emerging reserve currencies have been the Deutschemark, the Japanese yen and the Swiss franc. Whilst the estimated $8 to 10 billion in official Swiss franc holdings still seem small in comparison with the US dollar this ranks the Swiss franc third or fourth in official foreign exchange holdings at present.

Switzerland differs from the other reserve centers mainly in two respects. Switzerland is by far the smallest and the most open economy of the countries whose currencies function as international reserves. It will be argued that both of these differences accentuate the problems connected with the international use of a currency.

It might be helpful to clarify what is meant when the reserve role of a currency is discussed. International transactions in a currency can be classified in the following way:

Fritz Leutwiler is Chairman of the Governing Board of the Swiss National Bank, and Chairman of the Board of Directors and President of the Bank for International Settlements. He received his Ph.D. from the University of Zurich.

René Kästli presently heads the Economics Subdivision of the Swiss National Bank and lectures at the University of St. Gallen. He received his doctorate in 1970 from the University of Bern.

Use of a currency	in private transactions	in official transactions
as medium of exchange	(1) (transaction currency)	(2) (intervention currency)
as store of value	(3) (investment currency)	(4) (reserve currency)
as measure of value	(5) (reference currency) (unit of account)	(6)

In talking about the reserve role of the Swiss franc we are mainly concerned about the functions listed under numbers (2) and (4)[1], with occasional reference to the other functions.

In trying to tackle the question of the role of the Swiss franc in a multiple reserve system, the following analysis discusses first the problems for Switzerland of becoming a reserve center. The (market) forces which led to the involvement of the Swiss franc in the newly emerging multiple reserve system are then discussed. The possible policy choices and the actual policy choice of the Swiss National Bank with regard to this phenomenon are described next. A summary and some conclusions will conclude this paper.

2. Should We Bother About the Reserve Role of the Swiss Franc?

In the literature the gains resulting from the status of a reserve currency are stressed much more than the associated costs. Why then is it that the Swiss National Bank is concerned about the reserve role of its currency?

There are, no doubt, some benefits from being a reserve-currency center. As foreigners are willing to hold (more or less liquid) assets denominated in the reserve currency, the demand for such assets is bigger than it would be otherwise. This means that a given supply of such assets will yield less if they are denominated in a reserve currency.[2] The so-called seigniorage gains associated with a reserve currency refer to the same facts, although they are often described rather inaccurately as enabling a reserve currency country to finance a deficit in its current account merely by issuing domestic currency to foreigners. From what was said before it becomes clear that such a deficit can be financed more cheaply (the same is true for other debts, too).

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[1] The difference between the so-called primary and secondary reserve currencies seems to be that the primary reserve currency (the US dollar) is used without restrictions in all six functions while a secondary reserve currency does not or not fully serve the purposes mentioned.

[2] In this context it is not important whether the additional demand stems from private or official sources.

There are certain characteristics which make a currency a likely candidate for becoming a reserve currency. The same characteristics, stable political and economic environment, basically unrestricted capital movements, and a developed financial sector, also promote a wider use of a country's currency in private transactions. This has also some beneficial effects for such an economy: the growth of the financial sector will be stimulated and the exporters and importers are more likely to calculate and trade in domestic currency, thus diminishing the foreign-exchange transactions that would in turn decrease the costs and the foreign-exchange risks.

While our economy has certainly gained from the growing reserve role of the Swiss franc in recent years, there are also some disadvantages associated with this development. It will be argued that monetary policy has become more difficult and is less likely to succeed.

Since 1980 the Swiss National Bank has been setting a monetary target in terms of the monetary base.[3] The long-term goal consists of a substantial reduction of today's inflation rate of some 7 percent. In order to avoid too drastic shocks on the real economy, a gradual lowering of the inflation rate is intended. The reserve role of the Swiss franc can hamper this policy, mainly in two ways.

The money supply relevant to the Swiss inflation rate excludes for obvious reasons Swiss franc holdings by foreigners. If for example a shift between domestic and foreign demand deposits with Swiss commercial banks takes place this will alter the money supply in the full amount of the shift. But such a shift does not reduce the demand for base money analogously.[4] This implies that a certain course of base-money expansion — depending on the distribution between domestic and non-domestic demand deposits — is consistent with different courses of monetary policy. This is naturally not new, because it is well known that e.g. changes in interest rates alter the link between the monetary base and the money supply in a systematic way. These systematic changes are predictable and can therefore be taken into account in the course of monetary policy. The same systematic behavior cannot be assumed for the described shifts between domestic and non-domestic deposits. If the reserve role of the Swiss franc were to lead to a less stable demand for non-domestic deposits this would therefore increase the probability of pursuing an overly restrictive or overly expansive monetary policy.

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[3] From 1975 to 1978 a monetary target in terms of M_1 was set.

[4] In the demand for base money of the Swiss commercial banks the legal requirements have become more important in the last few years.

There is another potentially harmful effect of the growing international use of the Swiss franc on monetary policy. Switzerland is exporting some 40 percent of its GNP. Recessions or booms in the exporting industries therefore determine to a large degree the course of the whole economy. Foreign exchange rate movements that considerably change the competitive position of Swiss exporting industries produce heavy shocks to the real economy. It would appear that excessive exchange-rate movements become more likely the more a currency becomes a reserve currency. Sudden shifts from one reserve currency to another will trigger off overshooting revaluations or devaluations which are bound to create large fluctuations in overall real economic activity. This in turn will prompt the central bank to intervene heavily on the foreign exchange market, making it very probable that the central bank is forced to abandon other goals of monetary policy, such as a certain money supply goal.

The Swiss experience in the fall of 1978 illustrates this point quite well. In the first nine months of that year, the trade weighted exchange rate rose by some 20 percent, exceeding the inflation-rate differential by almost the same measures. This drastic deterioration of the competitiveness of Swiss exporters, was soon reflected in a drastic reduction of incoming orders. If this development had continued for some time we would have faced a serious recession. In this situation the Swiss National Bank decided to abandon its monetary target temporarily in favor of a foreign exchange rate goal. Not surprisingly this policy shift had effects not only on the foreign exchange rate but some time later also on the inflation rate. It is mainly the abundance of liquidity after the policy shift of 1978 which is responsible for the increase in inflation rates in Switzerland in the last two and a half years. We assume that the reserve function of the Swiss franc (and its growing importance as an international investment medium) was partly responsible for the drastic upward movement which eventually forced the Swiss National Bank to abandon the goal of a stable price level. The then widespread belief that the economic problems of the United States would persist for some time led to a rapid depreciation of the dollar. This in turn triggered an even bigger loss of confidence in the dollar, causing official and private investors to shift the currency composition of their portfolios. By such a move channelled to a great extent towards the Swiss franc, a large market (that in dollars) collided with a small market (that in Swiss francs) resulting in an unprecedented turmoil on the foreign exchange markets.

The considerations made here suggest that Switzerland is not too happy about its role as a reserve-currency center, even if this role may seem to be comparatively unimportant. It is felt that the reserve-currency function can cause the money demand to become less stable, therefore making a monetary-base policy less likely to succeed. Moreover, because of the openness of its economy, Swiss monetary policy has to be more sensitive to exchange rate movements, although the smallness of the Swiss economy is likely to create a comparatively high variability of foreign exchange rates.

3. Reasons for the Growing International Role of the Swiss Franc

The sharp fluctuations in foreign exchange rates since generalized floating was put into practice has led to a massive redistribution of wealth. Especially in the first few years after 1973, investors, whose portfolios consisted mainly of dollars assets, were on the losing side. The most simple means of reducing fluctuations in the value of a portfolio caused by foreign exchange rate fluctuations consists of a currency diversification of the financial assets.

In the early 1970s the dollar was the predominant reserve currency. Central banks therefore had in general a very one-sided currency composition of their portfolios. In our opinion — corroborated by some evidence — central banks as a group behave in such situations not very differently from private investors. We therefore think that the currency unrests of the mid-1970s created strong incentives for currency diversification by central banks.

The Swiss franc was a likely candidate for such a diversification. The "fundamentals", a stable political and economic environment (the most conspicuous parts of the latter being the comparatively low inflation rate and the persistent surplus on current account) and a well developed financial sector were apt to create confidence in our currency. At least up to 1978 the foreign exchange markets reflected this confidence by an almost unbroken revaluation of the Swiss franc. This general situation caused a strong additional demand for Swiss-franc assets.

There is another reason why the Swiss franc serves as a reserve-currency. Owing to the policy of the Swiss authorities to grant free access for all borrowers to our financial markets we have had very substantial capital exports. Borrowings by LDCs, either directly or through development organizations, have thereby proved to be sizeable. Most of these capital exports have led to debt denominated in Swiss francs. These liabilities assumed proportions of frightening magnitude in terms of other currencies when the Swiss franc appreciated heavily. Most of these debts having long maturities, hedging was possible only by acquiring Swiss franc assets. If the debtor is a government or a government agency, it is quite natural that they should endeavor to match the Swiss franc debts with a corresponding diversification of the currency reserves — if there are any.

The reasons that create a demand for Swiss franc assets by central banks also apply to private investors. Since we assume basically the same behavior by central banks and private investors we should — and actually do — observe a somewhat parallel growth of the Swiss franc use for investment and reserve purposes.

The basic reason behind the evolution of a dollar standard into a multi-currency reserve system is somewhat blurred by the extreme foreign exchange rate movements since generalized floating started. Foreign exchange rate movements are explained to a large degree by divergent monetary policy leading to different inflation rates and interest rates in different countries. Actual or supposed differences in monetary policy therefore tend to strengthen the move away from a one-currency-reserve system to a multi-currency-reserve system.

4. Policy Alternatives and the Policy Choice of the Swiss National Bank

The 8 to 10 billion dollars worth of official Swiss franc holdings mentioned at the beginning were built up in the 1970s.[5] At that time the Swiss National Bank pursued a policy which aimed at preventing the Swiss franc from becoming a reserve currency. That policy, naturally, was guided by the considerations mentioned earlier. From the figures it has to be concluded that this policy has failed.

This conclusion shows that there are certain policies which are bound to fail and, therefore, are not real alternatives. In order to get down to the policy choice it is necessary for the alternatives to be confined to those that seem likely to succeed.

By tradition, financial markets in Switzerland are comparatively little regulated. It is generally felt that this principle has proved successful and it would therefore be out of question to introduce highly interventionist measures such as a two-tier foreign exchange market and a prohibition of secondary market operations for Swiss franc bonds. But this implies that it is in fact not possible to prevent all transactions which would occur in order to circumvent certain new regulations if measures aiming at a limitation of the reserve role of the Swiss franc were taken. This also applies even more pronouncedly to foreign markets which are under no direct control by Swiss authorities. This in turn implies that it is no use introducing very strict measures in order to prevent the Swiss franc from becoming a reserve currency. Because financial markets tend to be very innovative these measures can be circumvented and, as the figures show, were actually circumvented. Therefore such measures will not be very effective.

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[5] The latest available figures are as of 1979.

There is another category of measures we judge to be not too successful. Declaring intentions and expressing wishes are of little avail if one has no assurance that those to whom the exhortations are directed will really act accordingly and if there is not even a minimal leverage to enforce intentions.

The conclusions from these general considerations are that we cannot really opt for the solution which would suit us best, namely to prevent the Swiss franc from assuming a reserve role. Therefore we have to look for the second-best solution.

As was pointed out before, it is not only the reserve role of the Swiss franc which bothers us, but also the use of our currency in private international transactions. Our policy therefore tries to get control over all (private and official) international transactions. In this respect two broad lines govern our policy. Firstly, it still seems sensible to avoid those developments that can be avoided. Secondly, it seems most important to be informed about what is happening, because this allows counteracting measures e.g. in response to a shift in the money-demand function.

As to the first point, this has the consequence that we are still trying to discourage some forms of an internationally-used Swiss franc. Two outstanding examples are: issues of Swiss franc papers outside Switzerland and the large-scale use of the Swiss franc in some currency baskets, such as the one which has been discussed for oil bills. With respect to the latter it is perhaps worth mentioning that we think it wrong to conclude that the Swiss franc would not be affected in any way if it were only included in a basket but not used as a transaction currency.

Basically we see two ways in which we can be better informed about the international use of our currency. We can either try to bring back Swiss franc business which has been done outside Switzerland so far, or we can seek more information about the use of the Swiss franc abroad. So far policy measures have concentrated on the former approach.

However, bringing back Swiss franc transactions to Switzerland is not so easy as it may seem. There are substantial international differences in the legal framework governing banking activities. This leads to rather big competitive advantages and disadvantages of certain banks in certain fields. In order to reduce these differences, some international coordinating measures have to be taken. It must therefore be hoped that the recommendations of the Bank for International Settlements (BIS) working group on Euromarket activities, to the effect that balance sheets of the banks should be consolidated and a certain evening out of competitive conditions should be achieved, will be followed. But there is no use waiting for these coordinating moves since such a coordination is, at best, some years ahead.

In our efforts to pursue a successful policy with regard to the international use of our currency we will therefore, for the time being, have to take the international institutional framework as given. In order to reduce competitive differences and thereby create incentives to shift back Swiss franc business to Switzerland, our national rules have to be changed. This was done in quite a consequent way for both capital import and capital export regulations.

Capital import regulations were used quite extensively in the past. In a system of fixed exchange rates this instrument was used in order to prevent excessive money creation. Due to the fact that Switzerland traditionally had a low inflation rate and ran a surplus on current account the Swiss franc tended to be strong. Since Swiss authorities were very reluctant to adjust the foreign exchange rate the official rate would not clear the market. Therefore substantial short-run capital inflows to Switzerland whenever a currency was expected to devalue (or the Swiss franc expected to revalue) translated into excessive growth rates of money supply. The measures used to restrict such growth were minimum reserve requirements, restricting the growth of credits, prohibiting banks to pay interest or charge a commission on Swiss franc deposits by foreigners.

Since generalized floating was introduced the main problems of Swiss monetary policy have been the strong and often overshooting movements of the foreign exchange rate. As was described earlier, these movements can have damaging effects on the real economy. Up to 1980 the main instruments used in the field of capital imports were the prohibition to pay interest and the charge of a commission (of up to 10 percent per quarter) on Swiss franc deposits by foreigners.

The efficacy of the measures mentioned were limited. This is not too surprising if one takes into consideration what was said earlier. As this was clearly understood and the general situation of a rather weak Swiss franc allowed such moves, a gradual dismantling of the capital import restrictions was started. In August 1980 the last step was taken when the interest ban on short-term deposits and the legal framework authorizing the Swiss National Bank to take such measures were lifted.

In Switzerland capital exports of Swiss francs 10 million and more are subject to approval. This instrument allows a considerable degree of influence over the international use of our currency. The rules governing these capital exports, revised in the fall of 1980, are again under scrutiny at the moment. It was also decided not to try to prevent developments that cannot be controlled. It is thought that a policy which tries to get as much knowledge as possible of the international role of our currency (in this context especially of central bank behavior) and which is aimed at bringing back to Switzerland transactions that were hitherto considered as undesirable will eventually show better results.

In view of the risks inherent in such an approach the change in policy has been careful and gradual. Consequently the steps taken by the Swiss National Bank in this respect have been rather undramatic if single moves are looked at, but still significant if taken as a whole.

Since the fall of 1979 the World Bank has been allowed to place four note issues of Sw Fr 200 million each exclusively with central banks. These issues have clearly shown that central banks behave at least in one way exactly in the same manner as do other investors: the better the yield in relation to market conditions, the higher the demand. We expect to carry on with this type of investment and hope to gain further insight into central bank behavior by means of these operations.

For some time we have been trying to develop a money market in Switzerland. This objective is being furthered by the issue of negotiable Money Market Debt Register Claims against the Swiss Government. These certificates are issued regularly to certain investors. In one of the small steps mentioned the group of potential investors was extended to foreign central banks, thus again creating additional incentives for them to operate through markets in Switzerland. Quite recently, Sw Fr 200 million of promissory notes of the Swiss National Bank were issued to another central bank. However, operations of such a kind are not open to all central banks.

Since September 1980 foreign central banks have been able to participate in all activities other market participants can conduct in the field of Swiss capital exports, subject to approval. In order to try to prevent potentially disturbing developments, special conditions were attached to such transactions. The central banks were asked to confirm in writing that they would hold their investments for their own account until maturity. It soon turned out that these conditions were too restrictive in order to achieve our goal of shifting central bank business back to Switzerland. Therefore the conditions mentioned will probably be relaxed soon.

In summing up the remarks concerning official policy in respect of the international use of the Swiss franc, it may be stated that today the Swiss National Bank is following a more realistic policy than it was in the 1970s. Nowadays, it is prepared to accept developments which have taken place, and it is not trying to prevent them, but rather to be better informed about them. This is done by means of bringing back transactions to Switzerland, and by close observation of the international role of the Swiss franc. With respect to the reserve role of our currency there have been and probably will be some moves in the direction of accommodating the needs of central banks better than in the past.

5. Summary and Conclusions

In the multi-reserve-currency system which has emerged since the move to generalized floating, the Swiss franc plays an important role, at least if this role is judged from our point of view. We think that the multi-reserve-currency system, in which the dollar will be predominant, is likely to be in existence for some time. Even if the dollar is recovering confidence at the moment, the risks for the participating central banks inherent in a one-asset-reserve system are too big.[6]

There has been a shift in the Swiss National Bank's attitude in so far as we no longer pretend that a multi-reserve-currency system has not emerged. Although we are not happy about the international role of the Swiss franc, we are ready to adapt policy measures to existing circumstances.

Some rather undramatic steps taken recently were aimed at acquiring more information concerning the international role of our currency. We strongly hope that improved information will enable us to react more efficiently and more quickly to developments which could endager the basic goals of monetary policy. In the long-run, though, national measures can solve only part of the problems. An international move aimed at evening out competitive advantages of the respective banking systems would greatly help in shifting business back to the home countries.

But even more important is the recognition that much of the move towards more international use of currencies is due to incentives created by extreme foreign exchange rate movements which in turn is accounted for by a monetary policy of some countries difficult to interpret, therefore leading to unstable expectations with respect to foreign exchange rates.

Since the international reserve will continue to be based on currencies of single countries, the monetary policy of the reserve-currency countries will be of utmost importance for the smooth functioning of such a system. If central banks will pursue a clear and clearly recognizable monetary policy geared at stable price levels, there will be no major disturbances in the system. Under these circumstances there will be no need for major reforms of such a system in the near future.

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[6] Since currency baskets have fixed weights, and portfolio diversification by maturities is more difficult to achieve with such assets we think that diversification will also in the future take place mainly by means of acquiring single currency assets and not assets denominated in some baskets.

The United Kingdom's Experience in Winding Down the Reserve Role of Sterling

Christopher W. McMahon

This paper traces briefly the history of the sterling balances since the early 1960s. End-year figures for these balances are shown in Table I. It concentrates on the official (country)[1], rather than the private, balances. The former were the main focus of official concern, being substantially larger during most of this period as well as being heavily concentrated with a small number of large holders, and thus potentially highly volatile. Of the official balances, the great majority were held by the traditional "Sterling Area" countries; in 1968 they held over 90 percent of all official balances. The note only considers developments that were specifically linked to the sterling balances, although a very large part of the UK's external policy, especially in the first part of this period, could be considered to be related at least indirectly to the sterling balance "problem".

In 1960 sterling still accounted for 38 percent of the world's currency reserves. By 1970 this had fallen to 13 percent, and by 1980 to only 2 percent. The sterling balance problem as such had originated in the second world war when holdings had increased sharply as United Kingdom suppliers had been unable to purchase goods with their sterling receipts. Between 1939 and 1945 total overseas sterling balances had risen from £517 million to £3,602 million. Policy after the war had aimed initially to increase the use of sterling as a trading and reserve currency. In return for

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[1] This excludes the holdings of international organizations, which largely represent UK subscriptions to these institutions and which have not displayed the volatility shown by country balances.

C.W. McMahon is Deputy Governor of the Bank of England.

holding their reserves in London, Sterling Area countries had access to the United Kingdom's foreign exchange reserves and to the London capital market, and to assist finance in London there was a so-called ring-fence of exchange controls between Sterling Area countries and the outside world

TABLE 1

Overseas Sterling Balances
millions of pounds: end year

	Exchange reserves in sterling held by central monetary institutions and international organizations[1]		Banking and money market liabilities to other holders
	CMIs	International organizations	
1962	2,223	89	1,551
1963	2,335	105	1,662
1964	2,326	110	1,704
1965	2,214	104	1,756
1966	2,187	117	1,684
1967	2,001	101	1,588
1968	1,803	117	1,460
1969	2,146	173	1,407
1970	2,365	182	1,673
1971	3,030	210	2,382
1972	3,361	257	2,291
1973	3,379	310	2,284
1974	4,303	331	2,500
1975	3,714	386	3,229[2]
1976	2,203	436	3,484
1977	2,132	703	4,965
1978	1,735	875	5,258
1979	2,218	1,102	7,839
1980	3,556	1,108	10,321
1981 June	3,817	1,101	11,511

Source: Bank of England Statistical Abstract and Economic Trends

[1] Excluding the International Monetary Fund

[2] £150 mn of increase due to improved reporting procedure

(although there were no UK exchange control against the Area), and various schemes were instituted, in the commodity markets and elsewhere, to encourage the use of sterling.

1. The First Basle Agreements

By the end of the 1950s, however, the benefits of Sterling Area membership had been substantially eroded, especially through the re-introduction of convertibility for sterling. The perennial weakness of the UK economy already encouraged Sterling Area countries to diversify part of their reserves out of sterling and the diminution of their former privileges served to increase this trend. In response to this, one of the main objectives of UK policy came to be to prevent such diversification or at least to prevent diversification occurring too rapidly.

During the 1960s there were sometimes sharp movements in sterling balances, particularly when sterling was under pressure, and these greatly exacerbated the repeated sterling crises[2]. For instance, in November-December 1964 there was a substantial rundown of the balances associated with the loss of confidence following new measures introduced by the incoming government. And in the summer of 1965 there was a further crisis of confidence following a sharp deterioration in the trade figures.

These crises were always liable to recur, given the endemic weakness of the economy. They were seen as a threat to international monetary stability as a whole, as well as inhibiting economic management in the United Kingdom, and this helped foster a willingness by overseas central banks to co-operate with the United Kingdom in seeking a solution to this problem. There was a feeling that some sort of funding arrangement might help and in 1965[3] the Basle central bank governors commissioned a study from the Bank for International Settlements (BIS) to examine the sterling balances. This study, by Dr. Milton Gilbert, the Economic Adviser of the BIS, clarified a number of issues on the nature of the balances, vis. that they were largely the liquid assets of governments, central banks, and private individuals, and that simplistic solutions, such as the conversion of the balances into long-term debt, would therefore not be feasible. It found that "the essence of the matter was that a severe balance of payments deficit, combined with a heavy flight from the currency, had left a position in which the reserves were about a minimum level, given that the ordinary sources of international assistance had been fully drawn upon. In these circumstances, any pressure on the reserves coming from the sterling balances would be a threat to the sterling parity."

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[2] Movements in sterling balances were regarded as destabilizing to the UK economy in that they only responded with a lag to economic conditions. For instance, payments deficits associated with booms were in their early stages financed by foreign inflows and this disguised the incipient problems and delayed counter-cyclical responses.

[3] There had been an earlier "Basle Agreement" in 1961 when the revaluation of the Deutschemark and the guilder prompted fears of a realignment of sterling and there were also a succession of 'swap lines' agreed, particularly with the Federal Reserve System. These were, however, not related specifically to the problem of the sterling balances.

Following this report and some protracted negotiations, eleven central banks agreed to set up a number of short-term agreements totalling about \$1 billion, largely three-month swap facilities, with the Bank of England. Their objective was to help smooth fluctuations in sterling balances and, being of such short duration, they were clearly not designed to assist their rundown. The Bank of England was only permitted to use the facility to cover a maximum of 50 percent (raised to 80 percent in September 1967) of reductions in the United Kingdom's reserves arising out of movements in the official and private sterling balances of the Overseas Sterling Area (OSA) and Non-Sterling Area (NSA)[4]. The agreements were renewed on virtually the same basis in 1967 and 1968.

2. Decline of Sterling

Nevertheless, the official balances contributed to the growing pressures on sterling in 1967, falling by nearly £200 million in the second half of the year. The devaluation in November 1967 came as a major shock to the system and was soon followed by widespread further diversification: in 1968 in the second quarter alone, official balances fell by almost £300 million. By this time the Bank of England was discussing at the BIS and elsewhere an extension of the earlier Basle Agreement. It was generally accepted that further diversification of OSA official balances was highly probable and it was calculated that to meet likely diversification, and to repay short-term debt, the United Kingdom would have to run such a large surplus as to be disruptive to world trade. Moreover, it was not even clear that an improvement in the United Kingdom's external position would help to finance diversification: rather it might have the perverse effect of increasing the amount that had to be financed since some diversification was at present being inhibited by recognition of sterling's exposed position. The conclusion was that an international support arrangement was required, for a considerably longer period than hitherto, with the objective of inducing sterling balance holders not to diversify their balances and, insofar as this objective was not met, of helping the United Kingdom to finance this diversification.

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[4] Falls in OSA balances were taken as affecting the UK's reserves by 66⅔% and NSA balances by 100%. An additional initial condition dropped in early 1968 was that drawings could not exceed by more than \$250 mn the amount of the United Kingdom's unused drawing rights on the IMF.

In the event a two-part package was put together. First, a $2 billion facility was provided by twelve central banks and the BIS to finance reductions in OSA official and private holdings below an agreed starting level. Drawings on this facility could be made during the first three years and repayment was required between the sixth and tenth years. The BIS was able to draw on three sources of finance to meet any drawings by the Bank of England: short- and medium-term borrowings in financial markets, deposits placed voluntarily with the BIS by Overseas Sterling Area central banks, and standby facilities of almost $2 billion provided by the twelve participating central banks. Secondly, agreements — mostly of three years' duration — were negotiated with over 60 OSA countries under which the UK government gave a dollar guarantee for the bulk of their official sterling provided that they held a minimum proportion of total official reserves in sterling; these minimum proportions varied according to the circumstances of individual countries.

As the level of balances was already below the trigger point when the Basle facility was authorized the Bank of England was able to draw $600 million in September/October 1968. The Agreements coincided with a series of other measures which restored confidence in sterling and the United Kingdom was therefore able to repay the entire $600 million by September 1969. The BIS did not need at any stage to call on the stand-by facilities provided by the participating central banks. The $2 billion facility was extended virtually unchanged for two years in 1971. It lapsed in September 1973, having been unused since September 1969 when the initial drawings were repaid.

The dollar guarantee arrangements had the desired effect of helping to stabilize the balances, but in a sense worked too well. In the years immediately following the agreement, the Sterling Area countries as a whole enjoyed balance of payments surpluses and the minimum sterling proportion clause had the effect therefore of *increasing* total sterling balances. In September 1968 OSA official balances were £1,506 million, by September 1971 they had risen to £2,760 million. These increases were a source of widespread concern and ensured that, when the guarantee agreements came up for renewal in 1971, the minimum sterling proportions — i.e. the fractions of total reserves each country was required to hold in sterling — were reduced by 10 percent. More significantly, as a result of concern expressed during negotiations over the UK's accession to the EEC, the British government indicated, in the 'Rippon letter' of January 1972 which was annexed to the Treaty of Accession, that they were "prepared to envisage an orderly and gradual rundown of official sterling balances after our accession".

There were two short-term renewals of the guarantees, in September 1973 and March 1974. In each case, as a discouragement to countries increasing their holdings, a ceiling was put on the amount the British government was prepared to guarantee. Following the generalized move to floating and the subsequent increase in volatility of exchange rates they became technically increasingly difficult to operate; moreover, especially after the inflow of oil money into sterling, a constantly decreasing proportion of official sterling was subject to these guarantees which therefore became largely irrelevant. When they were discontinued at the end of 1974, only 59 per cent of participants' sterling was covered.

As mentioned above, there was a substantial inflow of oil money into sterling after the first oil price shock, pushing official holdings to a peak of £4,512 million in the first quarter of 1975 causing a rather different set of countries from the traditional holders to become the major sterling holders. (This is not to deny that there was some important overlap between the two sets.) By 1975 OPEC countries accounted for over 70 percent of all sterling balances. The inflows financed the UK's external deficit in these years, again serving to conceal the extent of disequilibrium in the economy, and thereby — with much more serious effects than in the earlier cycles — delaying the necessary adjustment measures.

The extreme volatility of the sterling balances that had flowed into the United Kingdom in the aftermath of the first oil-price shock was demonstrated as soon as confidence factors were reversed. Official balances fell from their March 1975 peak of £4,512 million to £2,371 million by September 1976 — £900 million of this fall occurred in the second quarter of 1976 alone. These withdrawals were a major component of the sterling crisis of that year, and greatly strengthened the feeling that the maintenance of a residual reserve currency role for sterling was anachronistic.

3. A New Basle Facility

Towards the end of the year, as part of a whole series of measures and agreements designed to restore confidence, a third Basle Agreement was negotiated. Initially it seemed to be generally accepted that it should be on the lines of the 1968 Basle Agreement although without the exchange rate guarantees, but the eventual outcome was significantly different. It was quite clear from the start that potential participants in a facility regarded an agreement by the British government with the IMF on a program of measures to support the UK's application for a new IMF stand-by facility to be a necessary pre-condition for any substantive discussions. These discussions then took place after the agreement with the IMF in November 1976 and the new Basle facility was announced in January 1977. In the words of the Chancellor of the Exchequer at the time:

> "The purpose was not only to achieve greater international monetary stability and to ensure that sterling and the exchange markets ceased to be affected by pressures associated wtih any rundown of the official sterling holdings, but also to enable the British government to achieve an orderly reduction in the role of sterling as a reserve currency".

The 1977 facility differed from the 1968 facility in that the accompanying arrangements envisaged a rundown of the official sterling balances rather than stabilizing them at their pre-existing level. Eleven central banks (plus the BIS) made available a total of $3 billion for two years with an optional third year and repayment of any drawings was to be made over the succeeding four years. The Bank of England was entitled to draw on the facility for the full amount in the first year and 75 percent thereafter of any net fall in the official[5] sterling balances below an agreed figure (£2,165 million) but drawings could normally only be made when the UK's external reserves were below $6,750 million.

For their part, the UK authorities agreed to seek to reduce the official sterling balances to working levels by the sale of foreign currency securities and other appropriate means, and to seek that restraint should be exercised with respect to future increases in private sterling balances. The foreign currency securities were to be negotiable bonds of five to ten years' maturity, and no more than 75 per cent of them were to be denominated in US dollars.

In February and March 1977 officials from the Bank of England visited the 15 main holders to explain the new policy, to seek subscriptions to the proposed foreign currency bond issue, and generally to solicit support for the new arrangements. The results were remarkably successful. 15 holders subscribed a total of £395 million when the bonds — denominated in dollars, Deutschemarks, Swiss francs, and Japanese yen — were issued in April. Other holders agreed to reduce their sterling holdings by other means. By mid-June it was felt that any further reduction in the balances was unlikely since, with one or two exceptions, countries' balances were now down to working levels. Subsequently, the Bank of England continued actively to seek the support of official holders and the co-operation received is shown by the fact that even by end-1979 official holdings still stood at only £2,218 million despite the restoration of confidence in sterling in the intervening period and the fact that some holders had initially been holding unsustainably low balances that would clearly necessitate some reconstitution. Official balances have risen by about 75 per cent since the end of 1979 but even this increase is relatively small when considered in the context of the enormous OPEC surpluses that have accrued during this period and taking into account also the effects of world inflation.

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[5] Following the imposition of exchange control against the Sterling Area in 1972 there was no longer any differentiation between Overseas Sterling Area and Non-Sterling Area.

Because of the success of these measures, and the associated restoration of confidence in sterling, the Bank of England had no need to make recourse to the $3 billion Basle facility. This lapsed, unused, in February 1979 when the UK authorities decided not to take up the option to extend it for a third year.

4. The Private Balances

This paper has concentrated on the official balances, which have traditionally been regarded as the source of the sterling balance "problem." The policy of restraining their growth has ensured that official sterling balances are only now reaching in nominal terms the levels of 1974-5 — and are in real terms therefore still only about half of these levels — even after their marked increase following the second oil price shock. Private holdings are very widely dispersed (incidentally making it totally impracticable to approach individual holders as is done for the official balances) and for many years up to the mid-1970s were fairly stable, rising only slowly. Partly for these reasons, they were not covered in the 1977 Basle Agreement.

However, they have recently risen quite rapidly and, as Table 1 shows, they are now three times as large as the official country balances. The recent increase may be partly linked with the greater use of sterling by overseas banks since the abolition of UK exchange control in October 1979. Sterling lending by UK banks to these banks, which was restricted under exchange control, rose by £3 billion between October 1979 and June 1981, and on the other side of the balance sheet this was matched by an increase of the same amount in overseas banks' sterling deposits. Each is a manifestation of the growth of the Euro-sterling market and its closer integration now with the domestic interbank sterling market.

Appendix

The functioning of the ECU

Wolfgang Rieke

1. On December 5, 1978 the European Council, meeting in Brussels, adopted a Resolution establishing the European Monetary System (EMS). The Resolution stated that the European Currency Unit (ECU) "will be at the center of the system". The ECU is defined as a basket of currencies composed of specific amounts of all Community currencies (with the exception of the Greek drachma). On the entry into force of the EMS the ECU was equal in its composition to the former European Unit of Account (EUA), which was introduced in 1975. With effect from January 1, 1981 the ECU replaced the EUA in all its applications within the EEC.

   Originally, the shares of the individual currencies in the basket were fixed in accordance with the respective countries' shares in intra-Community trade, national product, and quotas in the EEC support mechanisms. The table below gives the components of the ECU basket and their weights. As fluctuations in exchange rates occur the relative weights of the component currencies in the basket are subject to constant change.

   Calculations of ECU values in each member currency are made as follows:

   > The central bank in each member state communicates at 2:30 p.m. a representative market exchange rate for its currency against the US dollar. The Commission uses these rates to calculate an ECU/EUA equivalent first in terms of dollar and then in the currencies of the member states. On July 31, 1981, the equivalent of 1 ECU/EUA in Deutschemark was DM 2,52297.

   The resolution of the European Council of December 5, 1978 provides for revisions in the ECU's composition every five years or, on request, if the weight of any currency has changed by 25 percent. Revisions are suggested upon mutual agreement, and are to be made in such manner as not to modify the external value of the ECU at the

		ECU[1]	ECU[1]		Percentage of total	
Currencies	Amounts of currency	= . . . currency units March 13, 1979	= . . . currency units July 31, 1981	March 13, 1979	July 31, 1981	June 28, 1974[1]
Deutschemark	0.828	2.51064	2.52297	33.0	32.8	27.3
French franc	1.15	5.79831	5.98467	19.8	19.2	19.5
Pound sterling	0.0885	0.663247	0.552238	13.3	16.1	17.5
Netherlands guilder	0.286	2.72077	2.80195	10.5	10.2	9.0
Belgian franc	3.66	39.4582	41.3326	9.6	8.9	8.2
Luxembourg franc	0.14		41.3326		0.3	
Italian lira	109.00	1,148.15	1,252.43	9.5	8.7	14.0
Danish krone	0.217	7.08592	7.92943	3.1	2.7	3.0
Irish pound	0.00759	0.662638	0.690297	1.2	1.1	1.5

[1] Percentages on the date the ECU was defined.

time of revision. As the underlying economic criteria remain the determining factors, such adjustments will not be made simply in proportion to the percentage of revaluation or devaluation of each individual currency's exchange rate.

Once the ECU achieves a more significant role in the private sector and/or vis-à-vis third countries, changes in its definition could pose problems similar to those of the SDR.

2. In the present initial stage of the EMS the key functions of the ECU are to serve as

   (1) *numeraire* for expressing central rates,
   (2) *denominator* for claims and liabilities vis-à-vis the European Monetary Cooperation Fund (EMCF) (claims and liabilities resulting from operations under the intervention and credit mechanisms, as well as reserve assets),
   (3) basis for establishing a *divergence indicator* which measures exchange rate divergences from the ECU central rate of the respective currency,
   (4) *means of settlement* between the monetary authorities of the European Economic Community as well as a *reserve asset* of EEC central banks.

The responsible national authorities of the participating countries, acting in agreement with their partners, have fixed a central rate for their currency in terms of the ECU. From these ECU central rates a "parity grid" of bilateral central rates is derived. The respective central banks are committed to defend these within agreed margins of fluctuation. Except for the Italian lira (which fluctuates within a margin of ± 6 percent) and the pound sterling (which fluctuates freely) the normal margin of fluctuation is $2^{1}/_{4}$ percent around the bilateral central rate. Changes in central rates are subject to the consent of all participants in the system. As a matter of convenience, adjustments in central rates have been made on the basis of bilateral revaluations or devaluations of certain currencies, and the calculation of ECU central rates has been carried out from the new bilateral central rates (incorporating imputed values for the pound sterling against the other member currencies). Since ECU central rates are linked with each other through their bilateral central rates a change in the ECU central rate of one currency necessarily leads to changes in the ECU central rates of the other currencies.

The creation of an *initial stock of ECUs* involves the transfer by each participating Community central bank of 20 percent of its gold and dollar reserves to the EMCF. These transfers take the form of three-month revolving swaps against ECUs which are to be unwound at the end of the initial stage. For the purpose of these swap transactions gold is valued at the average of the daily market price in dollars quoted in London over the past six months but no higher than the average price of the two fixing rates of the second but last business day of the period in question.

ECUs thus created may be used for settlement of 50 percent or more (upon mutual agreement) of any debtor balances arising from intervention within the EMS. To this purpose the amounts of a partner currency supplied for intervention under the very short-term financing operations are converted into ECUs at the ECU daily rate and entered in the accounts of the EMCF.

The resultant creditor balances can be used multilaterally by the creditor central banks concerned; they can be transferred to any other central bank participating in the exchange rate system in settlement of outstanding intervention liabilities. Interest is paid on the balances at a rate corresponding to the weighted average of the official discount rates of all Community central banks.

The ECU has so far performed these various functions satisfactorily, even if certain limitations in the working of the divergence indicator have come to light. Its role as an instrument for intra-Community settlements, however, is restricted in certain respects. First, settlements in ECUs, unlike settlements in reserve assets denominated in SDRs or US dollars, are not final, for the reasons explained below. Secondly, within the strict meaning of the Agreement, the right to use ECU holdings is limited to the settlement of debts financed through the EMCF and incurred as a result of mandatory interventions at the intervention points in the exchange rate mechanism, and then only up to 50 percent of the amounts involved. This acceptance limit for ECUs is designed to protect the interest of persistent creditor countries within the EMS that may need to use reserves for settlement vis-à-vis third countries. In the case of intramarginal interventions, the extent ECUs can be used for same-day settlement of intervention balances depends on arrangements agreed between the parties directly concerned. In the past, settlement in ECUs has substantially exceeded the volume that creditors were obliged to accept under the existing EMS rules.

Nevertheless, the ECU has become a reserve asset in its own right only to a very limited degree. This results from the fact that ECUs have been created against swaps, and ECUs accumulated by a central bank in excess of its reserve contributions are of a "precarious" nature, due to the obligation on net users of ECUs to reconstitute their original holdings by purchasing ECUs from the central banks that are net accumulators.

3. The Resolution of December 1978 envisages as crowning elements of a final "institutional phase" of the EMS the establishment of a European Monetary Fund (EMF) and full utilization of the ECU as a reserve asset and means of settlement.

   The creation of ECUs in the context of an EMF raises important issues relating to its money-creating powers and the safeguards (checks and balances) required. At present, the creation of ECUs depends largely on pre-set rules which do, however, contain elements of automatism that are subject to criticism (mainly the impact on the volume of ECUs outstanding of fluctuations in dollar exchange rates and even more so, of the dollar price of gold). It is generally agreed that in the final system the volume of ECUs created must correspond more closely to certain basic aims of the EMS, especially the achievement of greater external and internal monetary stability, as well as enhance the ECU's attractiveness as a reserve asset and monetary instrument of potential use outside the circle of EMS central banks.

4. From the viewpoint of private investors and borrowers the role of the ECU is at present closely circumscribed.

   Legal difficulties inhibit the use of the ECU even in its present limited role as a unit of account in certain countries. These problems arise, for example, from the existence of

   (a) exchange controls;
   (b) limitations in regard to banks' open foreign currency positions (such as those in Germany) that would apply to banks dealing in ECUs;
   (c) monetary and credit controls;
   (d) national laws of contract or other legislation which effectively restrict the use of the ECU.

   It is doubtful to what extent the ECU could provide a satisfactory means of reducing exchange rate risks or hedging costs in international trade, or even in intra-Community transactions in current circumstances, given the existence of such constraints. Nevertheless, the fact that the ECU cannot at present be used as a means of settlement does not preclude commercial contracts being drawn up involving the ECU as a unit of account. But it does mean that ECU operations have at some point to be broken down into the component currencies, whether this be for settlements, loans, deposits or forward cover. The complexity of the procedures involved is unlikely to encourage commercial firms to change their invoicing practices.

Even though the exchange rate risks may be reduced as compared with the use of individual national currencies, maintaining an ECU account or making payments in ECU still involves exchange rate risks. Despite these obvious problems, a number of European banks at present operate ECU accounts, though again the ECU is still only used as an accounting device. Thus, payments transfers in ECU, whether national or international, will in practice be effected in one or more of the component currencies. This procedure is laborious and costly and will tend to cause the bank's lending rate (deposit rate) to be higher (lower) than the weighted average of the interest cost (yield) on the individual currencies.

In order to achieve wider use of the ECU in banking transactions it would seem essential that the following legal conditions exist:

(1) The ECU is fully convertible;

(2) Residents of each Community country are free to hold ECU-denominated bank accounts as well as ECU denominated securities;

(3) The ECU must be capable of being used as a unit of account in commercial contracts.

The Deutschemark as a Reserve and Investment Currency

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TABLE 1

Currency Composition of Foreign Exchange Reserves[*]
End of Selected Quarters, 1973-80[1]

(in percent)

	1973:I	1975:IV	1976:IV	1977:IV	1977:IV	1979:IV	1980:IV	1979:IV Excluding ECU[2]	1980:IV Excluding ECU[2, 3]
U.S. dollar	84.5	85.4	87.0	85.7	83.5	66.5[4]	60.9[5]	78.9	74.7
Pound sterling	5.9	4.0	2.1	1.8	1.6	1.9	2.4	2.0	2.8
Deutshemark	6.7	6.5	7.1	8.0	9.6	10.3	11.5	11.3	13.2
French franc	1.2	1.3	1.0	0.8	1.0	0.9	1.0	1.0	1.2
Swiss franc	1.4	1.6	1.6	2.1	2.0	2.9	3.3	3.2	3.8
Netherlands guilder	0.4	0.6	0.5	0.4	0.5	0.6	0.7	0.7	0.9
Japanese yen	—	0.6	0.7	1.1	1.8	2.6	3.0	2.8	3.5
ECU	—	—	—	—	—	14.3[4]	17.2[5]	—	—
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Various Fund publications and Fund staff estimates.

[*] Share of National Currencies in SDR Value of Total Official Holdings of Foreign Exchange.

[1] The detail in each of the columns may not add to 100 because of rounding.

[2] In this alternative calculation, the SDR value of European Currency Units (ECUs) issued against U.S. dollars (SDR 12,784 million at the end of 1979 and SDR 10,176 million at the end of 1980) is added to the SDR value of U.S. dollars, but the SDR value of ECUs issued against gold (SDR 19,725 million at the end of 1979 and SDR 37,354 million at the end of 1980) is excluded from the total distributed here.

[3] The five-currency basket SDR has weights of 42 percent for the U.S. dollar, 19 percent for the Deutschemark, and 13 percent for each of the pound sterling, the French franc, and the Japanese yen.

[4] The share of U.S. dollars would rise by 5.8 percentage points and that of the ECU would fall by the same amount if ECUs issued against U.S. dollars were treated as U.S. dollars in foreign exchange reserves.

[5] The share of U.S. dollars would rise by 3.8 percentage points and that of the ECU would fall by the same amount if ECUs issued against U.S. dollars were treated as U.S. dollars in foreign exchange reserves.

Sources: IMF Annual Report 1981, as revised by Bundesbank on the basis of more recent Fund staff estimates.

TABLE 2

Development of International Bank Claims

(by Currency)[1]

Position at end		All currencies US-$ billion	Among which, in percent									
			US-$	DM	£	SwFr	FF	Yen[2]	Dfl	Bfr.	Lit	Other[3]
1974	March	320.89	71.8	14.0	1.6	8.0	1.2	0.3	0.8	0.7	0.4	1.2
	June	342.40	72.6	13.8	1.5	7.7	0.9	0.4	0.7	0.8	0.4	1.2
	Sept.	334.88	73.7	13.3	1.4	7.0	0.8	0.4	1.2	0.8	0.3	1.2
	Dec. I	357.77	72.7	14.7	1.3	7.0	0.8	0.4	0.9	0.8	0.3	1.2
	Dec. II	360.21	72.3	14.7	1.2	7.0	0.8	0.4	1.3	0.8	0.3	1.2
1975	March	375.34	71.2	15.9	1.2	6.7	0.9	0.4	1.4	0.8	0.3	1.2
	June	396.78	71.7	15.5	1.4	6.5	1.0	0.3	1.4	0.8	0.3	1.2
	Sept.	410.43	72.9	15.1	1.2	6.1	0.9	0.3	1.5	0.7	0.3	1.4
	Dec.	441.44	73.2	15.3	1.0	6.0	0.9	0.3	1.3	0.7	0.2	1.0
1976	March	458.77	72.7	15.5	1.0	6.1	0.8	0.4	1.4	0.7	0.2	1.1
	June	477.31	73.7	14.4	1.0	6.2	0.8	0.4	1.4	0.7	0.2	1.2
	Sept.	500.84	73.2	14.7	1.0	6.2	0.8	0.4	1.5	1.0	0.2	1.2
	Dec.	548.02	73.8	14.9	0.8	5.7	0.8	0.4	1.5	0.8	0.1	1.2
1977	March	546.89	73.7	14.5	0.9	5.8	0.8	0.4	1.6	0.8	0.1	1.3
	June	572.04	73.0	15.0	0.9	5.8	0.9	0.4	1.7	0.9	0.1	1.3
	Sept.	590.67	72.6	14.8	1.0	6.0	1.0	0.5	1.6	0.9	0.1	1.4

	Dec. I	657.25	71.2	16.4	1.0	6.1	0.9	0.5	1.5	0.9	0.1	1.3
	Dec. II[4]	689.67	68.6	16.0	2.5[5]	5.9	2.2[6]	0.8	1.5	0.9	0.1	1.6
1978	March	711.26	67.4	16.2	2.6	6.2	2.5	1.1	1.6	0.9	0.1	1.5
	June	736.31	67.7	15.2	2.7	6.2	2.7	1.3	1.7	0.8	0.2	1.5
	Sept.	803.63	66.3	15.7	2.7	6.9	2.7	1.5	1.8	0.8	0.2	1.4
	Dec. I	904.68	66.9	16.5	2.5	5.6	2.7	1.5	1.8	0.8	0.2	1.5
	Dec. II	893.10	66.5	16.7	2.6	5.7	2.7	1.5	1.8	0.8	0.2	1.5
1979	March	883.50	65.8	16.4	2.7	5.7	2.9	1.7	2.0	0.9	0.2	1.6
	June	946.48	65.3	16.8	2.6	6.3	2.8	1.7	1.9	0.8	0.2	1.7
	Sept.	1.041.50	65.4	16.6	2.5	6.6	2.8	1.6	1.9	0.9	0.2	1.7
	Dec.	1.110.67	65.7	16.5	2.5	6.3	2.9	1.6	1.9	0.9	0.2	1.5
1980	March	1.117.41	66.9	15.5	2.6	6.2	2.8	1.8	1.7	0.9	0.2	1.5
	June I	1.205.87	65.1	16.1	2.8	6.6	2.9	2.0	1.7	1.0	0.2	1.6
	June II	1.206.23	65.1	16.1	2.8	6.6	2.9	2.0	1.7	1.0	0.2	1.6
	Sept.	1.248.06	66.0	15.3	2.8	6.6	2.9	2.1	1.6	0.9	0.2	1.5
	Dec.	1.321.92	67.6	14.3	2.8	6.3	2.8	2.1	1.5	0.8	0.2	1.5
1981	March I	1.346.72	68.3	13.8	2.8	6.4	2.7	2.2	1.5	0.7	0.2	1.4
	March II	1.348.80	68.4	13.8	2.8	6.4	2.7	2.2	1.5	0.7	0.2	1.4
	June	1.346.66	70.5	12.3	2.6	6.4	2.3	2.3	1.4	0.6	0.2	1.4

Source: BIS, Statistics of Euro-currency and other International Banking, Federal Reserve Bulletin

[1] External assets in domestic and foreign currencies of banks in countries reporting to the BIS (including banks in the U.S. and foreign branches of U.S. banks in certain offshore financial centers).

[2] Excluding Yen assets of Swiss banks.

[3] Including Yen assets of Swiss banks.

[4] From December 1977 including banks in Austria, Denmark and Ireland.

[5] From December 1977 including all commercial bills and acceptances.

[6] From December 1977 including buyers' credits to foreign importers.

TABLE 3

Composition of Foreign Exchange Reserves by Country Groups

First quarter of 1980 in percent[1]

	All countries	Industrial countries		Oil exporting Others	Non-oil countries	LDCs
		All	EMS			
Dollar	78.1	87.2	90.2	82.7	67.0	67.6
Pound sterling	2.3	0.7	0.5	1.1	2.9	5.5
Deutschemark	11.7	6.9	5.7	9.0	16.7	17.6
French franc	1.0	—	—	—	2.2	2.3
Swiss franc	3.1	2.7	2.9	2.7	5.1	1.9
Dutch guilder	0.7	0.4	0.5	—	1.1	1.5
Japanese yen	3.1	1.9	0.2	4.5	4.8	3.8
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0

[1] *Source:* IMF. Average levels of foreign exchange reserves expressed in SDRs and excluding ECUs (the value of ECUs issued against gold is excluded and the value of ECUs issued against dollars is added to the value of dollar holdings).

TABLE 4

Total Official and Private Deutschemark Claims Held by Non-residents*

(in DM billion)

End of	Cross-border DM claims of non-residents on banks outside Germany (1)	External DM bonds held by non-residents (2)	Total cross-border claims on external DM markets held by non-residents (1) + (2) (3)	Other DM claims on Germany held by non-residents (4)	Total cross-border claims in DM held by non-residents (3) + (4) (5)
1970	23.9	9.8	33.7	. . .	. . .
1971	43.9	14.1	57.1	. . .	. . .
1972	57.7	22.3	80.0	. . .	. . .
1973	77.7	25.1	102.8	. . .	. . .
1974	69.9	25.0	94.9	90.2	185.1
1975	82.7	30.3	113.0	105.3	218.3
1976	90.1	36.5	126.6	122.3	248.9
1977	124.2	43.9	168.1	144.7	312.8
1978	152.8	50.3	203.1	177.3	380.4
1979	201.8	55.9	257.7	202.8	460.5
1980	217.5	58.9	276.4	251.6	528.0
June 1981	218.7	57.1	275.8	289.9	565.7

Sources: IMF, Bundesbank, BIS
Details see other tables
* In this table: non-residents = non-residents of Germany.

TABLE 5

Overall Statistically Recorded Deutschemark Assets and Total Foreign Exchange Reserves of Monetary Authorities

End of	Deutschemark assets in Germany		Deutschemark assets in the Euromarket[1]		Total Deutschemark assets		Foreign exchange reserves				*Pro memoria:* Official Euro-currency holdings[2] (BIS debtor statistics)[3]		
							Total	Excl. ECUs against gold		of which Euro-currency holdings	Total[4]	of which Deutschemark assets	
								Total	Excl. reserve holdings of Bundesbank				
	DM billion	US$[5] billion	DM billion	US$ billion	DM billion	US$ billion	US$ billion	US$ billion	US$ billion	US$ billion	US$ billion	US$ billion	DM billion
1975	7.7	2.9	17.5	6.7	25.2	9.6	160.9	160.9	138.2	52.6	52.4	7.6	20.0
1976	11.5	4.9	17.0	7.2	28.5	12.1	186.3	186.3	160.8	61.3	64.0	8.3	19.7
1977	14.8	7.0	23.2	11.0	38.0	18.1	245.7	245.7	215.0	79.9	75.4	12.0	25.2
1978	20.5	11.2	26.4	14.5	46.9	25.7	289.7	289.7	247.4	82.9	85.8	16.8	30.7
1979	24.6	14.2	27.7	16.0	52.3	30.2	326.5	300.6	260.5	86.2	121.4	24.1	41.7
1980	42.0	21.4	38.5	19.6	80.5	41.1	376.0	328.3	297.7	98.5	128.0	24.5	47.9
1981													
June	42.4	17.7					356.5	316.7	283.1	101.6	113.9	18.4	43.9

Source: International Monetary Fund, Creditor Statistics: International Financial Statistics, IMF Survey, Monthly Report on Balance of Payments Developments, and other unpublished data.

[1] Including unknown holdings of external Deutschemark bonds.

[2] With banks in countries reporting to the BIS.

[3] Bank for international Settlement: Quarterly press release on International banking developments.

[4] Including foreign branches of US banks in certain offshore financial centers.

[5] Dollar figures are DM equivalents in U.S. currency.

TABLE 6

Various Shares of DM Holdings in Official Portfolios

(in percent)[1]

	Excluding ECUs issued against gold[2]						Including ECUs issued against gold	
	1975	1976	1977	1978	1979	1980	1979	1980
I. Based on official holdings of								
All countries	6.0	6.5	7.4	8.9	10.1	12.5	9.3	10.9
All countries excl. Germany[3]	7.0	7.5	8.4	10.4	11.6	13.8	10.8	12.4
II. Based on official holdings excl. an undistributed residual[4]								
All countries	6.5	7.1	8.0	9.6	11.3	13.2	10.3	11.5
All countries excl. Germany	7.6	8.3	9.2	11.5	13.4	14.6	12.4	13.0

Source: International Monetary Fund and Bundesbank estimates.

[1] Absolute figures see Table 5.

[2] Since 1979 reduction of the amount of total official holdings of foreign exchange by the total value of ECUs issued against gold.

[3] i.e. after deduction of the official reserve holdings of the Deutsche Bundesbank.

[4] The "undistributed residual" comprises reserves reported to the IMF in minor currencies and reserves whose currency composition is not fully identified.

TABLE 7

Outstanding Deutschemark-denominated Bonds Placed in Germany and Abroad

(billions of Deutschemark)

	Domestic issues						Foreign DM issues[4]		
		Among which bonds placed abroad						Of which placed with non-residents	
Amount outstanding at end of	Total placed in Germany and abroad[1]	Total[2]	in %	Issued by banks	Issued by public sector	Issued by enter-prises[3]	Total placed in Germany and abroad	net	in %
Dec. 1970	155.1	5.1	3.3	1.9	1.3	1.9	19.4	9.8	50.5
Dec. 1971	176.2	6.7	4.0	2.9	1.5	2.3	22.7	14.1	62.1
Dec. 1972	210.9	14.4	6.8	8.0	2.2	4.2	26.7	22.3	83.5
Dec. 1973	237.2	21.1	8.9	14.7	2.7	3.7	29.3	25.1	85.7
June 1974	245.2	21.6	8.8	15.9	2.6	3.1	29.0	. .	
Dec. 1974	263.2	18.7	7.1	13.6	2.4	2.7	29.9	25.0	83.6
June 1975	291.2	17.3	5.9	12.5	2.5	2.3	35.1	. .	
Dec. 1975	311.9	15.3	4.9	12.1	1.8	1.4	35.9	30.3	84.4
June 1976	336.8	16.2	4.8	11.5	3.0	1.8	39.3	. .	
Dec. 1976	360.1	18.5	5.1	11.5	4.8	2.3	42.6	36.5	85.7
June 1977	383.9	17.9	4.7	10.8	5.1	2.0	47.8	. .	
Dec. 1977	411.3	19.3	4.7	10.9	6.3	2.1	52.9	43.9	83.0

June 1978	436.9	19.3	4.4	9.8	7.2	2.3	59.0	47.7	80.8
Dec. 1978	452.2	19.6	4.3	9.0	7.9	2.7	63.2	50.3	79.6
June 1979	474.4	19.3	4.1	8.0	8.6	2.6	65.4	52.5	80.3
Dec. 1979	494.4	23.7	4.8	9.4	11.4	3.0	70.1	55.9	79.7
June 1980	527.7	24.4	4.6	9.2	12.0	3.2	74.9	57.3	76.5
Dec. 1980	540.5	24.0	4.4	9.1	11.8	3.1	79.2	58.9	74.4
June 1981	582.7	24.3	4.2	9.4	11.7	3.1	78.1	57.1	73.1

Source: Deutsche Bundesbank

[1] Face value, excluding holdings by issuers.

[2] Cumulated transaction values; face values are probably in general slightly higher.

[3] Including Federal Railways and Federal Post Office.

[4] Floated by German-managed syndicates.

TABLE 8

Development of Euro-Deutschemark Currency Market[1]

(in percent)

Position of reporting banks	End of period								June 1981
	1967	1970	1975	1976	1977	1978	1979	1980	
DM claims of international banks									
Total									
in billions of DM	**8.3**	**37.2**	**112.2**	**118.7**	**151.7**	**182.7**	**220.5**	**247.4**	**267.8**
(in billions of US$)	*2.1*	*10.2*	*42.8*	*50.2*	*72.1*	*99.9*	*127.3*	*126.3*	*112.0*)
				Percentage Shares					
On Germany		**50.1**	**31.8**	**33.2**	**34.4**	**34.0**	**31.1**	**35.2**	**38.6**
Banks		32.8	13.3	15.1	14.8	15.6	16.8	15.4	15.9
Non-banks		17.3	18.4	18.1	19.7	18.3	14.3	19.8	22.7
On other countries[2]		**49.9**	**68.2**	**66.8**	**65.6**	**66.0**	**68.9**	**64.8**	**61.4**
Banks		40.0[3]	49.9	50.1	51.7	52.2	55.3	52.5	49.7
Non-banks		9.9	16.8	14.9	13.0	12.7	12.7	11.6	11.1
Monetary institutions		. .	1.5	1.8	0.9	1.1	0.9	0.7	0.6

DM liabilities of international banks									
Total									
in billions of DM	**6.8**	**29.8**	**107.0**	**114.0**	**146.9**	**173.3**	**225.5**	**252.2**	**255.3**
(in billions of US$)	*1.7*	*8.2*	*40.8*	*48.3*	*69.8*	*94.8*	*130.3*	*128.7*	*106.8*)
					Percentage Shares				
To Germany		**19.7**	**22.7**	**20.9**	**15.5**	**11.8**	**10.5**	**13.8**	**14.4**
Banks		17.2	21.4	18.3	13.5	10.1	8.9	11.2	10.7
Non-banks		2.5	1.3	2.6	2.0	1.8	1.7	2.6	3.6
To other countries[2]		**80.3**	**77.3**	**79.1**	**84.5**	**88.2**	**89.5**	**86.2**	**85.6**
Banks		66.9[3]	51.6	54.5	60.4	63.0	64.5	61.0	62.3
Non-banks		13.4	7.0	7.0	7.0	7.4	6.5	6.2	6.2
Monetary institutions		. .	18.7	17.3	17.1	17.7	18.5	19.0	17.2

Source: BIS, Statistics of Euro-currency and other international banking.

[1] Assets and liabilities of banks in 12 European countries (Austria, Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom), Canada and Japan. Austria, Denmark and Ireland are included from December 1977 onwards.

[2] Excluding Euro-Mark-positions vis-à-vis residents in reporting countries.

[3] Including Euro-Mark-positions of the reporting banks vis-à-vis official monetary institutions.

TABLE 9

Foreign Deutschemark Assets in Germany*

(billions of Deutschemark)

Item	1974		1975		1976		1977		1978		1979		1980		1981
	Mid	End	Mid	End	Mid	End	Mid	End	Mid	End	Mid	End	Mid	End	Mid
In the German banking system															
(a) Bundesbank	1.5	2.2	1.5	1.9	2.0	2.4	2.1	2.0	2.9	6.9	6.0	5.0	4.5	10.2	14.1
(b) Banks[1]															
Short-term[2]	19.7	19.7	19.3	26.6	24.8	27.6	26.3	33.5	28.2	42.0	35.9	43.4	38.2	43.3	43.1
Long-term															
Financial credits	5.9	6.6	6.0	7.6	9.5	11.6	12.9	15.7	21.7	29.6	38.3	48.7	53.6	54.1	54.2
Bonds	15.9	13.6	12.5	12.1	11.5	11.5	10.8	10.9	9.8	9.0	8.0	9.4	9.2	9.1	9.4
Total	41.5	39.9	37.7	46.2	45.7	50.7	50.1	60.0	59.7	80.6	82.2	101.5	101.0	106.4	106.7
Total	42.9	42.1	39.2	48.1	47.7	53.1	52.2	62.0	62.6	87.4	88.2	106.5	105.5	116.6	120.8
With enterprises and individuals															
Short-term															
Financial credits	8.2	10.6	13.3	13.5	16.2	13.9	16.7	21.6	21.0	22.7	22.2	20.3	33.1	33.0	43.3
Trade credits in the form of advance payments	9.7	12.4	14.1	14.9	16.7	16.8	17.6	18.2	19.7	18.8	20.6	20.7	21.2	19.9	22.5
Other assets[2]	—	—	0.1	0.0	0.0			0.1	0.2	0.1	0.1	0.1	—	—	0.3
Total	17.9	23.0	27.5	28.5	32.9	30.8	34.4	39.9	40.8	41.6	42.9	41.0	54.3	52.8	65.8

Long-term															
Financial credits	9.9	10.1	10.7	10.8	10.7	11.0	11.9	12.5	12.6	13.2	13.4	14.5	15.6	18.5	21.5
Portfolio investment															
Shares[3]	6.7	6.8	8.0	8.6	9.4	10.3	11.1	11.9	13.1	14.9	15.5	16.7	16.7	17.3	17.8
Bonds[4]	3.1	2.7	2.3	1.4	1.8	2.3	2.0	2.1	2.3	2.7	2.6	3.0	3.2	3.1	3.1
Total	19.8	19.6	21.0	20.8	21.9	23.5	25.0	26.4	28.1	30.8	31.5	34.2	35.5	38.9	42.4
Total	37.7	42.5	48.5	49.3	54.8	54.2	59.3	66.3	68.9	72.4	74.4	75.2	89.8	91.8	108.2
With public authorities[5]															
Long-term															
Financial credits[6]	0.8	1.9	1.7	4.7	6.8	8.9	9.2	8.7	8.7	8.1	8.2	8.0	16.7	29.6	43.5
Bonds	2.6	2.4	2.5	1.8	3.0	4.8	5.1	6.3	7.2	7.9	8.6	11.4	12.0	11.8	11.7
Total	3.4	4.3	4.2	6.5	9.7	13.7	14.3	15.1	15.9	16.0	16.8	19.4	28.8	41.3	57.6
Deutschemark notes[7]	1.8	1.3	2.0	1.4	2.1	1.3	2.3	1.4	2.4	1.5	2.7	1.7	2.9	1.9	3.3
Total	85.8	90.2	94.0	105.3	114.3	122.3	128.2	144.7	149.8	177.3	182.1	202.8	226.9	251.6	289.9

Source: Deutsche Bundesbank

* Excluding direct investment, other capital holdings, periods allowed for payment in foreign trade, and real estate; partly estimated.

[1] Classified in accordance with the banking statistics.

[2] Excluding liabilities arising from undistributed profits.

[3] Including investment in German bank shares.

[4] Including bond issues of the Federal Railways and Federal Post Office.

[5] Excluding short-term liabilities, but including U.S. investment in Federal Government borrowers' notes.

[6] Including U.S. investment in Federal Government borrowers' notes.

[7] Deutschemark notes held by foreigners (estimated).

(Discrepancies in the totals are due to rounding.)

TABLE 10

Statistically Recorded Deutschemark Assets of Foreign Monetary Authorities in Germany

(billions of Deutschemarks)

			Statistically identified by Deutsche Bundesbank					Pro memoria: *Net DM borrowing* by public sector in Germany (in year or quarter respectively)	
			With Bundesbank		Deposits with banks				
End of year or quarter	IMF creditor data	Total	Deposits	Mobilization and liquidity paper	Short-term (1 year or less)	Medium and long-term	Discrepancy[1]	Total	Among which from OPEC countries and U.S.A.[2]
1970	4.7	4.1	0.2	1.9	2.0	0.1	0.0		
1974	6.9	2.6	0.7	0.8	1.1	0.0	4.3	+ 1.2	+0.4
1975	7.7	3.3	0.3	1.0	1.5	0.6	4.4	+ 3.5	+1.5
1976	11.5	4.1	0.2	1.4	1.4	1.1	7.3	+ 4.3	+1.1
1977	14.8	6.1	0.2	1.1	3.6	1.2	8.8	− 0.2	+0.6
1978	20.5	12.4	3.9	2.2	3.7	2.7	8.1	− 0.6	−0.8
1979	24.6	10.5	2.2	1.6	3.0	3.6	14.1	+ 0.3	−0.1
1980 March	29.2	11.9	2.7	1.7	3.4	41.	17.3	+ 5.5	+5.4
June	30.5	11.8	1.5	1.9	3.7	4.6	18.7	+ 3.3	+2.6
Sept.	35.0	12.3	2.0	2.0	3.7	4.6	22.7	+ 3.4	+2.2
Dec.	42.0	18.9	6.8	2.4	4.8	4.9	23.1	+10.3	+7.4
1981 March	42.6	21.4	9.6	3.4	3.3	5.1	21.2	+ 8.6	+7.2
June	42.4	21.0	9.8	3.3	2.6	5.2	21.4	+ 6.8	+5.3

Sources: IMF, Deutsche Bundesbank.

[1] Mainly holdings in domestic Deutschemark bonds and public sector borrowers' notes of indebtedness.

[2] Assuming that most of these borrowings constitute increases of official and quasi-official reserves.

TABLE 11

Newly Arisen German Export Claims by Currency

(On the basis of quarterly averages in percent)

Period	DM	US$	£	SwFr	FF	BFr	hfl	Lit	Other[1]
1972	84.1	6.5	1.2	1.0	2.6	0.8	1.2	1.2	1.4
1973	85.5	5.3	1.1	0.9	2.6	0.7	1.2	1.1	1.6
1974	88.3	3.8	0.9	0.8	2.2	0.7	1.1	0.8	1.4
1975	89.2	4.4	0.9	0.5	1.7	0.6	0.9	0.7	1.1
1976	86.9	5.0	1.2	0.6	2.1	0.7	0.9	1.1	1.5
1977	86.0	6.2	1.1	0.5	2.1	0.7	0.9	1.0	1.5
1978	83.6	7.4	1.3	0.5	2.3	0.8	1.1	1.0	2.0
1979	82.6	7.3	1.5	0.5	2.6	0.8	1.1	1.3	2.4
1980	82.5	7.2	1.4	0.5	2.8	0.9	1.2	1.3	2.2
1980 I	81.6	7.6	1.5	0.5	2.8	0.9	1.2	1.6	2.3
II	82.5	7.0	1.6	0.5	2.8	1.0	1.2	1.4	2.0
III	82.8	7.1	1.3	0.5	2.8	0.9	1.2	1.1	2.3
IV	83.2	7.1	1.2	0.5	2.6	0.8	1.1	1.2	2.3
1981 I	81.6	7.9	1.3	0.5	2.9	0.9	1.2	1.4	2.3
II	82.2	7.9	1.2	0.4	2.7	0.9	1.1	1.3	2.3

Source: Deutsche Bundesbank

[1] A more detailed breakdown is not possible.

TABLE 12

German Import Payments by Currency

(On the basis of quarterly averages in percent)

Period	DM	US$	£	SwFr	FF	BFr	hfl	Lit	Other[1]
1972	49.9	18.6	4.9	1.9	4.3	2.2	3.4	7.5	7.3
1973	.	.	.	.	.	.	.	.	.
1974	42.2	28.3	4.8	1.7	4.2	2.2	3.0	3.2	10.4
1975	42.5	30.9	3.6	1.7	4.2	1.8	2.6	2.7	10.0
1976	42.0	31.3	3.2	1.7	3.9	1.7	2.5	3.1	10.6
1977	44.2	30.6	3.0	1.7	3.7	1.7	2.3	2.1	10.7
1978	46.1	28.5	3.3	2.1	3.7	1.7	2.4	2.4	9.8
1979	43.7	30.5	3.2	1.7	3.4	1.7	2.1	2.9	10.8
1980	43.1	32.3	3.3	1.6	3.3	1.6	2.0	2.4	10.4
1980 I	43.5	33.5	3.2	1.7	3.3	1.9	2.2	2.7	8.0
II	42.2	33.9	3.0	1.4	3.3	1.5	2.0	1.8	10.9
III	42.7	31.8	3.1	1.5	3.2	1.6	1.9	2.8	11.4
IV	43.8	30.1	4.1	1.8	3.2	1.5	1.8	2.3	11.4
1981 I	42.7	34.1	3.5	1.9	3.3	1.2	2.0	2.1	9.2
II	43.0	32.2	3.0	1.6	2.9	1.3	2.1	2.2	11.7

Source: Deutsche Bundesbank

[1] A more detailed breakdown is not possible.

TABLE 13

Major Items of Germany's Balance of Payments

(billions of Deutschemark)

	1973	1974	1975	1976	1977	1978	1979	1980	First half 1981
A) Current account									
Foreign trade	+33.0	+50.8	+37.3	+34.5	+38.4	+41.2	+22.4	+ 8.9	+ 6.4
Balance	+12.3	+26.6	+ 9.9	+ 9.9	+ 9.5	+18.4	− 9.6	−29.8	−14.5
B) Private capital transactions									
Long-term capital exports	− 0.7	− 9.5	−21.9	−17.6	−20.9	−20.9	−18.7	−27.4	−12.0
Long-term capital imports	+15.9	+ 4.1	+ 2.5	+13.7	+ 9.6	+21.2	+31.0	+12.9	+ 6.9
Short-term capital transactions	+ 0.0	−19.0	+ 4.3	+ 1.0	+12.7	+ 7.2	− 0.6	− 0.8	+10.3
Banks	(− 5.1)	(− 9.7)	(− 2.3)	(+ 6.7)	(+ 8.1)	(+10.1)	(+ 4.3)	(− 9.3)	(+ 1.9)
Enterprises and individuals	(+ 5.2)	(− 9.3)	(+ 6.5)	(− 5.7)	(+ 4.6)	(+ 2.9)	(− 5.0)	(+ 8.5)	(+ 8.3)
of which trade credits	(+ 4.6)	(−12.4)	(+ 4.1)	(− 5.7)	(− 3.9)	(− 3.9)	(− 1.7)	(− 4.8)	(− 3.3)
of which financial credits	(+ 0.6)	(+ 3.1)	(+ 2.5)	(− 0.0)	(+ 8.5)	(+ 1.1)	(− 3.2)	(+13.3)	(+11.9)
Balance	+15.2	−24.4	−15.1	− 2.9	+ 1.4	+ 7.6	+11.7	−15.3	+ 5.2
C) Official capital transactions									
Long-term	− 2.2	− 0.9	+ 1.2	+ 2.4	− 1.6	− 3.3	− 1.5	+21.4	+12.8
Short-term	+ 0.3	− 0.0	+ 0.7	− 0.6	− 0.0	+ 1.2	− 0.3	− 0.4	+ 1.5
Balance	− 2.0	− 0.9	+ 1.8	+ 1.8	− 1.7	− 2.1	− 1.8	+21.0	+14.3

D) Balance of unclassifiable transactions	+ 0.9	− 3.2	+ 1.1	− 0.1	+ 1.2	− 4.1	− 5.2	− 3.7	+ 2.2
Overall balance on current and capital accounts	+26.4	− 1.9	− 2.2	+ 8.8	+10.5	+19.8	− 5.0	−27.9	+ 7.2
Change in the net external assets of the Bundesbank (increase: +)	+16.1	− 9.1	+ 3.3	+ 1.3	+ 2.6	+12.2	− 7.3	−25.7	+ 6.8

Source: Deutsche Bundesbank, Monthly Reports and Statistical Supplements, Series 3.

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Group of Thirty

How Central Banks Manage Their Reserves

A study by the Office of the Group of Thirty
on behalf of the Multiple Reserve
Currency Study Group

Study Group Members
H.J. Witteveen

Geoffrey Bell
Peter Kenen
Alexandre Lamfalussy
Fritz Leutwiler
Christopher McMahon
Jacques J. Polak
Wolfgang Rieke
Robert V. Roosa
Anthony M. Solomon
Robert Solomon

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How Central Banks Manage Their Reserves

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How Central Banks Manage Their Reserves

PREFACE

This report on reserve currency diversification has been undertaken by the Group of Thirty in cooperation with central banks holding more than half of the world's foreign exchange reserves. The aim is to shed new light on a development of considerable importance to the international financial system — the evolution of a multiple currency reserve system.

The move to a *de facto* multiple currency reserve system (MCRS) has far-reaching implications for the authorities in the older and newer reserve centers as well as for those who are diversifying their reserves. Central banks in each of these categories are among those who have contributed to the study. The Group of Thirty hopes that the study it has undertaken may contribute to a clearer appreciation of the benefits and drawbacks of the process. This in turn may help both central banks and international institutions in their quest for policies of the greatest practical benefit to the international financial system.

The report is based on central banks' replies to questions that were drawn up by a study group under Dr. H.J. Witteveen, chairman of the Group of Thirty and former managing director of the IMF. The membership of the study group is shown on the title page. As in the case of previous surveys by the Group of Thirty, respondents were promised absolute confidentiality; answers were seen by the staff of the Group alone.

This study is published in conjunction with a booklet, "Reserve Currencies in Transition" consisting of essays by Dr. Wolfgang Rieke of the German Bundesbank, Mr. Michiya Matsukawa of Nikko Securities, Dr. Fritz Leutwiler and Dr. René Kästli of the Swiss National Bank and Mr. Christopher McMahon of the Bank of England. The booklet contains an introductory article by Mr. Robert V. Roosa, a partner in Brown Brothers Harriman and a former Under Secretary for Monetary Affairs at the US Treasury. In his article, Mr. Roosa discusses the background to the evolution of the multiple currency system and explores various approaches to reducing its possible instability. The article draws on extensive discussions of these topics at meetings of the study group.

The Group of Thirty wishes to express its thanks to the central banks that participated in the study; and to Mr. M.S. Mendelsohn, who took the leading role in compiling the report. Final responsibility for the report remains, however, with the undersigned.

April, 1982

Robert Pringle
Executive Director
Group of Thirty

How Central Banks Manage Their Reserves

Summary of the Report

Although the world has been moving towards a multicurrency reserve asset system during the past decade, this is the first study of its kind to examine the extent of that shift, its possible growth and its implications for the older and newer reserve centers, for reserve holders, and for the stability or otherwise of the international financial system.

The study breaks new ground in being the first to be based on the evidence and views of central banks themselves, in answers to a questionnaire supplemented, in some cases, by interviews. The 22 central banks which cooperated in the study hold more than half of the world's total of about $350 billion of foreign exchange reserves. They include the monetary authorities of most of the Group of Ten countries* and of the most important oil exporting countries as well as central banks of smaller industrial countries, NICs (or Newer Industrialized Countries) and a number of non-oil LDCs. The study has been supplemented by interviews with 12 international commercial and investment banks, because a large proportion of official reserves and other official foreign exchange holdings are placed with such banks in the leading domestic money markets and the

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* The Group of Ten countries are the United States, the United Kingdom, Japan, Germany, France, Italy, the Netherlands, Belgium, Canada and Sweden. Switzerland cooperates independently in the work of the Group.

Euromarkets. The trend of reserve asset diversification since 1970 is shown in provisional and hitherto unpublished estimates (pages 30-32).

The principal findings

The fact of reserve asset diversification has now been attested for the first time by an important cross section of leading central banks. And, contrary to a widespread impression, diversification has by no means been limited to oil exporters and developing countries. Although some members of the Group of Ten continue to hold their foreign exchange reserves almost exclusively in dollars, excepting for minimal working balances in other currencies, several leading industrialized countries indicate that they have been diversifying some of their own reserves into currencies other than the dollar in the past five years. Moreover, even those central banks that have not as yet begun to diversify by currencies have, like the others, begun to manage their assets more actively than before in terms of the investment instruments chosen.

The dollar, however, remains unique in retaining all the functions of a reserve currency, above all in being the world's only intervention currency for all practical purposes. It is true that the Deutschemark has come to be used for official intervention too, but as yet mainly within the European Monetary System and on a limited scale even within that. The other reserve currencies like sterling, the yen, the Swiss and French francs and the Dutch guilder represent foreign exchange assets for the holders, but they are not fully-fledged reserve currencies because they are not used directly for official intervention in the markets.

The original impetus to diversification came from the collapse of the Bretton Woods system and the floating of exchange rates. This motivated many countries to try to maintain the real value of those assets or at least to increase the return on them.* The replies further suggest that the desire to spread the exchange risk on the large accrual of reserves to raw material producers after the commodities' boom of 1972/73 and to oil producers after 1973 and 1979 contributed to reserve asset diversification. So, in the view of respondents, did the desire to match foreign liabilities and assets following the large increase in balance of payments borrowing from 1973 onwards by industrial as well as developing countries. Changing patterns of trade have played their part and so have wide fluctuations in interest rates since 1979.

The Euromarkets provided a channel for diversification from the start. More recently, other channels have been provided by the relaxation of restrictions

* "Real" dollar interest rates were negative from 1972 to 1977 and only marginally positive from 1977 to early 1980.

on foreign official holdings of Deutschemark, yen, Swiss franc and Dutch guilder resulting, in part, from the current payments deficits of those countries at various times since 1979. However, the Euromarkets continue to attract central bank placements because of the higher yields available, as well as the flexibility and anonymity of these markets.

Diversification will continue, in the view of most respondents, although they see limitations to that process, partly because very few countries have markets of a breadth and depth which would make their currencies suitable as foreign official assets on any significant (or significantly larger) scale: one referred specifically to the shortage of liquid money market instruments in the 'new' reserve currencies — others to the 'narrowness' of non-dollar markets generally.

Countries that are large borrowers can achieve most of their diversification goals by a more active management of their debt structure; the replies yielded some evidence to substantiate this point, which was made by a G-10 central bank.

The maintenance of a currency mix appropriate to the pattern of foreign trade and of external indebtedness was seen as the most important influence on the management of reserves at present.

MCRS in practice

Destabilizing . . . In the view of most central banks who cooperated in this study, the trend towards the MCRS may have a marginally destablizing influence, but they attribute the main causes of instability in exchange and interest rates to unstable economic conditions and monetary policies; moreover, the impact of switching by official holders is thought to be much less than that of private investors.

. . . or, stabilizing? However, several other respondents believe that the MCRS may actually contribute towards stability at the margin, by spreading responsibility for adjustment among more centers. In particular, in such a system the dollar faces competition from other currencies and this "may tend to constrain dollar creation." Official currency switching can reinforce the signals for economic adjustment to the older and newer reserve centers and thus contribute to prompter adjustment by those centers when necessary.

Active portfolio management of part of their reserves by a growing number of central banks is tending to blur the distinction between their behavior and that of other participants in world financial markets. The impact on the financial system may vary greatly according to whether official "diversified portfolios" are managed aggressively (like "performance funds") or cautiously. The evidence suggests that some central banks tend towards the first course and others towards the latter.

"Rational" behavior by "large new holders of reserves, primarily OPEC countries" was favorably commented on by a G-10 central bank. Similar observations were made by a few other central banks, acknowledging the profit-oriented yet prudent portfolio management policies of some of these large new reserve holders. Such policies will tend to have a stabilizing influence on the exchanges.*

"Irrational" behavior, on the other hand, was reported by several commercial bankers. They said that diversified reserve holders often act "perversely" by selling out of falling markets and buying into rising markets, thus contributing to exchange rate instability. One investment banker spoke of "wild and ill-informed trading" in currencies and commodities by some of his official clients, adding that they frequently lose money.**

Policy issues

The de facto MCRS is here to stay, according to most respondents. "We cannot go back to the dollar alone or forward to the SDR" said one G-10 central banker. Most central banks surveyed expect the SDR's role to remain modest, and there was surprisingly little difference of view between industrial and developing countries. Nor did most respondents see an alternative to the MCRS in a substitution account of the type proposed in 1979/80, which would have substituted SDR claims on the IMF for some of the official dollar claims on the US. At the same time, most respondents doubt whether any general understanding could be reached between reserve centers and holders on rules or guidelines for diversification, although several thought the idea worth exploring.

Other policy issues arising from the replies were the following:

1. In the view of several central banks, the extent of further reserve diversification will be strongly influenced by US monetary policy and the American authorities' attitude to the dollar's exchange rate including, but not limited to, intervention policy;
2. Replies suggest that insofar as measures to reduce exchange rate instability associated with an MCRS might be desirable, central banks look in the first instance to the central banks of reserve centers to make the necessary arrangements with each other;

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* An example of this has been publicly provided by Mr. AlQuraishi, the Governor of the Saudi Arabian Monetary Authority. He has said that SAMA's policy is to buy into falling markets and to stay in or sell out of rising markets. *The Banker*, London, July 1981, page 77.

** One example, recently reported, referred to estimated losses of "well over $25 million, or as much as the paid-up capital" of the Abu Dhabi Investment Company, created in 1977 as a merchant bank and investment vehicle for that state's official funds. *The Economist Financial Report*, December 10, 1981.

3. Further, the replies taken together suggest that if the financial community should at some point in the future wish to move decisively away from the dollar, a successor to the dollar would have to fulfill all the functions of a reserve currency, including particularly its ability to serve as a means of direct intervention in the foreign exchange markets.

Conclusions

Most of the respondents to this survey believe that there is no practical alternative to the *de facto* MCRS that has come into being. They foresee a further if limited tendency towards reserve currency diversification and more active asset management through a wider range of market instruments by reserve holders. Most of them see little prospect of official management of the phenomenon; but they do not seem to be strongly concerned about this.

Some central banks believe reserve diversification adds marginally to international financial instability. Others believe that it does or could make a marginal contribution towards the stabilizing of exchange relationships. The outcome would seem to depend partly on the extent to which official asset holders perceive an identity between their own longer-term investment interests, and the contribution which that perception could make towards stabilization.

The Development of a Multi-Currency Reserve System

Report on Central Banks' Replies
to Questionnaire

PART 1: THE MANAGEMENT OF RESERVE ASSETS

1. Please list in order of importance, in your personal opinion, the factors that have contributed to the process of reserve currency diversification by many central banks in recent years (comments on those factors would be helpful):
   - i) the expectation of long-lasting trends in exchange rates, such as a depreciation of the US dollar
   - ii) short-term fluctuations in exchange rates without regard to trend
   - iii) interest rate instability
   - iv) changing trade patterns
   - v) a new desire for capital inflows on the part of some industrial countries
   - vi) a new desire to increase the overall return on reserve assets on the part of central banks
   - vii) a desire to match the currency composition of reserve assets with that of external liabilities
   - viii) the ready availability of diversification opportunities through the Euro-currency (or comparable) markets

Respondents' answers

Nearly all agree that the dollar's almost continuous decline and large exchange rate fluctuations from 1971 onward gave the original impetus to reserve diversification and more active reserve asset management.

The replies suggest that, once started, the main factor contributing to diversification and more active reserve asset management was the desire of many countries to maintain the real value of their resources at a time of steeply rising liquidity or at least to increase the return on their assets. That became additionally important for commodity producers whose reserves increased substantially after the 1972/73 raw materials' boom and for oil exporters whose reserves rose sharply after the large increases in world oil prices in 1973 and 1979. Reaction to wide interest rate fluctuations coming on top of large exchange rate fluctuations from 1979 then became an important further influence motivating central banks to increase the return on reserve assets or maintain their value through currency diversification and active portfolio management. In other words, respondents tended to list the "factors" in the sequence of their influence over time, rather than in their relative importance at any given moment.

The desire to match foreign exchange liabilities and assets acquired growing importance on changing patterns of trade and even more so because of heavy balance of payments borrowing by many countries after 1973. Several banks also stated that foreign currency matching became important in guiding the direction and extent of diversification rather than originally motivating diversification.

Finally, there are the markets that have contributed to diversification and more active asset management, as distinct from motivating those trends. The Euromarkets make possible diversification both by currencies and the location of where assets are held. They were well established even before reserve diversification began, but have grown significantly during the past decade both in size and in the variety of investment instruments available. More recently, some countries have partly eased the restrictions they formerly imposed on the use of their currencies as reserve assets in response to deteriorations in their balances of payments, notably Germany, Japan, Switzerland and the Netherlands.

2. Do you expect that a general process of reserve currency diversification will persist?

Respondents' answers

The reply was an almost unanimous "yes" excepting from one central bank which said it was unsure and another which declined to answer this question. The reason most commonly given was summed up by a Group of Ten central bank which said: "Diversification is likely to persist under conditions of strongly growing liquidity and indebtedness combined with instability of interest and exchange rates." "There is no alternative," said another G-10 central bank which added, as most respondents did explicitly or implicitly, that it foresees no early return to enduring international financial stability. The matter was put somewhat differently by a third G-10 central bank which said, "Even periods of dollar strength may also serve to permit diversification with more ease and less embarassment to the United States". At another level, the central bank of one of the smaller Latin American countries said that its reserve diversification would be "strictly tied to the development of our foreign trade and foreign capital inflows".

3. Have the objectives, or priorities among the objectives, of your reserve policy changed significantly over the past five to ten years? If there have been significant changes, could you indicate what they have been and the principal reasons for them?

Respondents' answers

More than half the respondents reported no fundamental change in objectives or priorities in the past five or even ten years, although several said that they had improved their techniques of diversification and asset management over time. However, a minority did report changes of objectives. They include:

- A G-10 central bank which said that its initial objective had been to maintain cover for its non-dollar liabilities. More recently, its diversification had "moved towards a more positive approach to a more balanced portfolio";
- Another G-10 central bank similarly reported that large exchange rate movements had recently made it more "sensitive" to the need for stabilizing the value of its reserves by holding a more balanced portfolio of currencies other than the dollar;
- A third G-10 central bank said: "One new objective for our reserve policy has been established over the last five years: to achieve a currency mix in reserves which at least to some extent reflects official indebtedness. Furthermore, the yield aspects of reserve management have become more important over the past five years";
- A fourth G-10 central bank reported that it had made modest gold

sales in recent years so that more of its reserves might be invested in interest-bearing securities;

- The central bank of a smaller, European industrial country said that it had taken advantage of the recent relaxation of restrictions in secondary reserve centers to acquire a portfolio of assets which "is now well spread over a range of currencies";
- The central bank of an industrial country outside the G-10 said it had shifted to a new emphasis on liability management in recent years by arranging short-term credit lines to be drawn down in times of external deficit and repaid in times of external surplus;
- An oil producing country said it had progressively adapted its reserve management policy to reflect higher oil earnings and the diversification of its imports during the 1970s.

4. Recognizing that there are wide differences between the policies of different central banks, particularly with regard to reserve diversification, if you now hold a number of currencies in your reserves, could you please indicate which of the following considerations are important influences on your present management of those reserves (comments would be appreciated):
   i) asset preservation over the longer term
   ii) maximization of total yields over the longer term (i.e. yields after allowing for appreciation or depreciation of currencies held)
   iii) opportunities for more active portfolio management
   iv) maintenance of a currency composition appropriate to patterns of international trade in goods and services
   v) maintenance of a currency mix appropriate to the currency structure of overseas indebtedness
   vi) protection against the possibilities of an asset freeze in one center
   vii) continuity of relationships with international commercial banks on the part of monetary authorities that place some of their reserves with commercial banks

Respondents' answers

The maintenance of a currency mix appropriate to the pattern of foreign trade and external indebtedness was cited as the most important influence by a majority of respondents, closely followed by the desire for asset preservation over the longer term and maximization of yields, which were given equal importance. Very little importance was attached to the other influences cited. One European central bank summarized this by saying: "The matching of external assets and liabilities is the most important factor for us. Asset preservation and yield maximization come next. The other factors are insignificant or have no importance at all".

There was no discernible difference of emphasis in the answers received from central banks in the G-10, other industrial, oil-exporting and developing countries, excepting that the five central banks which declined to answer this question included three from the Group of Ten which said that the question did not apply to them because they continue to hold nearly all of their foreign exchange reserves in dollars excepting for minimal working balances in some other currencies.

The central bank of a small industrial country said that the first stage of its reserve management was the selection of a desired currency mix with the object of preserving so far as possible the real value of its reserves at minimum risk. Having taken that long-term view, the bank added that it does not switch frequently between currencies. The second stage of its reserve management consists of selecting investment instruments in each of the currency markets chosen, but with prudential limits for various portfolio variables; "for example the time weighted average life of investments, the maximum maturity for bonds, the maximum proportion that may be invested in bonds, the maximum that may be placed with commercial banks, and so on".

Although the monetary authorities of oil exporting countries were among the minority which referred to the risk of an asset freeze as one influence on their reserve management, they rated it low down among their considerations.

5. If you presently aim for some further currency diversification, what factors limit or might limit the process in your case? The following lists a number of possible constraints (again comments would be appreciated):
    - i) reimposition (or increasing likelihood) of restrictions on non-residents in-flows by some reserve currency countries
    - ii) limit in the number of domestic financial markets of sufficient size to offer scope for large-scale diversification
    - iii) political pressure by some recipient countries to limit official capital inflows from abroad
    - iv) slower growth in the breadth and depth of some of the biggest existing financial markets
    - v) concern over the reliability of "extra-territorial" markets for providing the liquidity appropriate for reserve assets

Respondents' answers

Nearly half the respondents to this questionnaire did not answer this particular question on one of two grounds: that they had not diversified their foreign exchange reserves, or that they do not at present intend any further diversification.

Those that answered cited as the two most limiting factors the possible reimposition of restrictions on official non-resident holdings in some of the newer, secondary reserve centers and the limited number of domestic financial markets of a sufficient size to offer scope for large-scale diversification. Far less importance was attached to the other possible limitations cited, like the possibly slower growth of the bigger existing financial markets and the liquidity of extraterritorial markets.

Among the comments made was this, by a central bank in the Group of Ten: "Restrictions on non-resident capital inflows might become a constraint again, not so much because ways will not exist of getting around such constraints but because the spirit of central bank cooperation, at least among G-10 and certain other countries, would inhibit their use."

6. Moving from the objectives to the instruments of policy, do you think that central banks in general manage their reserves more actively than formerly (say, five to ten years ago), in the sense of changing maturity structure and asset composition? Would you judge that your own management has become more active?

Respondents' answers

With the exception of two respondents which did not answer this question, all said that they believe central banks generally manage their reserves more actively than in the past and that they themselves did so. The respondents who gave this reply include several banks of the G-10 countries, some of which say they have been doing so partly by currency diversification. Others, which still hold their foreign exchange reserves almost exclusively in dollars excepting for minimal working balances elsewhere, nevertheless said that they now manage the maturity structure of their dollar assets more actively than before. "We have widened the number of our investment instruments in the United States", said one.

One major G-10 central bank, which said it had begun currency diversification of its own reserves in the latter 1970s, added: "Certainly our own management has become more active, but regular contacts with other G-10 countries suggest growing activity among some of their number".

The monetary authority of an important oil-exporting country referred to the "advantages of applying the principle of portfolio management to foreign exchange reserves in a world of floating currencies". However, it added a cautious note, "As a risk-averse institution, a central bank has to think of ways of reducing the political and economic risks of reserve holdings placed abroad. This implies a mix in its reserve holdings in terms of currencies and location".

7. A significant proportion of reserve currency diversification, especially on the part of oil exporters, developing countries and some smaller industralized countries has been through the Euromarkets. What, in your opinion, are the main reasons?
    i) greater confidentiality
    ii) absence of controls
    iii) higher yields
    iv) greater flexibility in amounts, timing, and choices of liquid assets

Respondents' answers

Higher yields followed by greater flexibility were cited as the main attractions of the Euromarkets as a channel for reserve diversification. Confidentiality and the absence of controls were ranked about equally in third place.

One bank pointed out that in the early days of reserve currency diversification the Euromarkets were often the only channel available. But, it added, even before diversification many central banks had become accustomed to the higher returns obtainable from commercial banks in the reserve centers compared with the returns on the government obligations of reserve currency countries held at the central bank of those countries.

Another central bank pointed out that in the case of the Deutschemark, the absence of controls in the Euromarket was especially important by contrast with restrictions on non-resident investment in the German domestic market (with similar restrictions applying in several other centers).

The central bank of an industrial country remarked that its credit facilities at international commercial banks influenced the deployment of its currency reserves through those same banks, often in the form of Eurocurrency deposits.

A point made by the central bank of a smaller European country was that although it was attracted by the higher yields obtainable in the Eurocurrencies interbank markets, in the case of bonds it preferred to invest in foreign domestic bond markets rather than the Eurobond market, because of the greater liquidity of the former.

Two LDC central banks were among the minority of respondents which cited the greater confidentiality of the Euromarkets as their greatest attraction.

Several respondents recalled that the placement of funds in the Euromarkets by the central banks of the Group of Ten and Switzerland remains limited under an understanding reached between them in 1971 and renewed in 1979.

8. Is the average maturity of your holdings of claims denominated in the "new" reserve currencies markedly different from that of your dollar holdings?

Respondents' answers

A majority of respondents holding "new" reserve currencies said that the average maturities of such holdings were no different from those of their dollar assets.

A minority, however, said that the maturities of their dollar holdings were, on average, shorter. The reason was given by one of these central banks which said, "The dollar continues to be our main intervention currency and therefore requires a higher degree of liquidity than others".

By contrast, two central banks of smaller industralized countries said their "new" reserves were held at shorter average maturities than their dollar assets because of the lesser degree of liquidity in the "new" reserve centers.

Those central banks which reported no marked difference between the average maturities of their dollar and other currency assets explained that their overriding concern was high liquidity in whatever currencies they invested. Indeed, this strong liquidity preference seems to be common to many respondents, their differing answers suggesting merely differences in tactics for achieving a common objective.

Making a slightly different point, a European central banker said that the maturity of his bank's reserves is influenced by their level rather than their currency composition; the higher the reserves in relation to the outlook for the balance of payments, the longer the maturities of assets the central bank could afford to hold in whatever currency.

9. How frequently do you review your policy guidelines with regard to reserve composition and take decisions as to appropriate changes?

Respondents' answers

The difference in the degree of actual surveillance may be less than suggested by the variety of answer to this question. Some banks said they reviewed policy annually, others at intervals of six months, monthly, weekly or "continously". In reality, most respondents said that changes were made whenever developments seemed to make them appropriate.

"Investment policy is examined as often as necessary depending on developments in the markets" said an LDC central bank. "Decisions are taken in response to exchange rate developments and market intervention needs" said a G-10 central bank.

A different point was made by a European industrial country's central bank, which said that although it kept its reserve composition under regular review, it changed the composition of its reserves only infrequently on the basis of a medium to long-term view.

The monetary authority of an oil exporting country said it likewise did not change the composition of its foreign exchange reserves frequently. "Furthermore, operations have to be conducted in such a way as to have a minimum impact on exchange markets".

10. In implementing your policy decisions, do you effect transactions through other central banks, or domestic or foreign commercial banks, or brokers, or other partners?

Respondents' answers

Most respondents said they dealt through all channels, including foreign central banks, commercial banks, investment banks, and, in two cases, also through securities houses. Only some banks, however, deal through brokers.

A G-10 central bank said it dealt with other central banks, domestic and foreign commercial banks and brokers. It added, "It is also possible to diversify passively through receipts from customer business".

The central bank of an industrial country outside the European and American area said its reserve transactions were conducted mainly with foreign commercial banks, adding, "The dollar balances at the New York Federal Reserve Bank are our only sizeable holdings with a central bank".

Only two respondents said they dealt exclusively or almost exclusively with foreign central banks alone. At the other extreme, a newly industrialized country said, "We seldom engage in reserve transactions with central banks".*

PART 2: THE EVOLUTION OF THE SYSTEM

11. Hitherto, reserve currency diversification appears to have been greatest among oil-exporting countries, developing countries, and some smaller industralized countries. Do you think that the practice may spread to the bigger industralized countries over time?

Respondents' answers

The answers to this question confirmed yet again an important development referred to also in answers to previous questions. While it is true that countries outside the Group of Ten have been most active in the currency diversification and portfolio management of their reserves, some G-10 central banks have also begun to diversify the currency composition of their reserves while others, who have not as yet taken that step, have nevertheless begun to manage their dollar holdings more actively.

Most respondents to this question expect reserve currency diversification to spread over time also to those large industralized countries that still hold their reserves in dollars alone, excepting for some working balances in other currencies.

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* Relations between central and commercial banks long predated diversification. Several occupied European countries held assets at American commercial and investment banks from 1939 to 1945 or even earlier and maintained relations with them thereafter. In addition, a number of foreign central banks used US commercial and investment banks for transactions in US government securities and in consequence held some of their dollar balances with those banks. This, in turn, generated other business between New York banks and foreign central banks. Long-established relationships therefore existed to help get reserve asset diversification under way, once it started. Many central banks, especially in non-industrial countries, hire western commercial and investment banks to manage parts of their reserves. Typically, the amount to be managed is allocated to the commercial or investment banks every six months and the management fee is usually between 5 and 10 basis points, or 0.05 to 0.1 per cent of the assets managed. Under an arrangement described as fairly widespread, one developing country employs three commercial and investment banks to manage parts of its reserves. If any of the three banks performs less well than the other two for two successive periods of six months, its contract is ended. The information in this footnote was derived from private bankers interviewed in connection with this survey.

One large G-10 bank reported that "There is already some evidence of diversification among the larger industrial countries and this is likely to continue, especially when they adopt a strategy of public sector external borrowing". Another G-10 central bank stated: "Many of the reasons for reserve currency diversification also seem applicable to larger industralized countries". Yet another said, "Some of the larger countries appear to have shown some interest in reserve currency diversification and this may spread, for example, in the context of the EMS".

A central bank from a non-G-10 industrial country pointed out that, contrary to the view implied in the question, LDCs had in fact been "slow to catch on"; LDCs did not diversify on a large scale "until huge upheavals in the markets and the examples of some industrial countries persuaded them to do so".

The central banker who made this observation mentioned two leading G-10 countries which "were aware much earlier of what was happening," adding "all those with flexibility have already diversified to some extent".

Several central banks based their replies on the expectation, or supposition, that the motives for diversification outlined in answers to question 1 would continue to apply but some stated that they expected the practice to spread only if monetary cooperation between the major countries were to break down.

Two central banks from the European Community (EC) took the view in almost identical language, that the extent of diversification would largely depend on US exchange rate policy. Others pointed out that the room for maneuver was limited by the size of some countries' reserves, and the commitment of leading countries to attempt to ensure "orderly markets".

Only two respondents answered the question unambiguously in the negative. They were both from the Middle East. "There is little likelihood of such a spread because the big industrial and other countries face different circumstances", said one of them.

12. What, in your opinion, are the merits and demerits of the SDR as a reserve asset? What growth do you expect in the official use of the SDR. Will its growth offer a useful alternative to the multiple reserve asset system now prevalent?

Respondents' answers

Only one central bank, from a small country, said that it expected the SDR to become in time a practical alternative to the multiple reserve asset system (and even that respondent qualified its answer). The great majority of central banks expect its role to remain modest, and there was surprisingly little difference of view between industrial and developing countries. Respondents dwelt on the disadvantages of the SDR, sometimes expressing these in terms of the changes that would have to be made for the SDR to become more usable. Among these, the most frequently mentioned were its limited usability (not only acceptance and designation rules and the balance-of-payments "need" requirement, but also that it is not an intervention asset and not transferable to the private sector). Other drawbacks cited were its lack of a range of maturities, relative lack of liquidity, and "lack of anonymity"; and that as an asset its yield, while "stable", is almost certainly lower than the average return on liquid assets held by central banks in the markets of the currencies making up the SDR "basket". For many countries its currency composition was not deemed appropriate to their patterns of trade or the composition of their external debt. For the system as a whole, it would also be necessary to control the growth of other reserve assets before the SDR could assume a dominant, or even an important, role. Several banks saw no justification for further allocations at present.

13. What growth do you foresee in the private market use of SDRs and how far might greater official and private use reinforce each other? Do you foresee circumstances in which the SDR could be used for intervention?

Respondents' answers

Central bankers appeared skeptical about the scope for growth in the use of the SDR in commercial transactions in the absence of (1) a demonstration of confidence in it by governments, such as further allocations and IMF borrowing denominated in SDRs in the markets; and (2) greater interest on the part of borrowers. To some extent official and private use has already reinforced each other, for instance through Fund borrowing from surplus countries denominated in SDRs. The simplification of the SDR valuation basket to the five leading currencies has certainly helped to encourage greater private use.

Central banks did not envisage the SDR being used for intervention in the foreseeable future. This could be foreseen only if private holdings of the IMF's SDRs were permitted and the IMF instituted a clearing mechanism. "Strong opposition by many countries to privately-held SDR accounts because of the fear that they will undermine the collective management of reserves is likely to operate against the use of the SDR for intervention purposes," said one central bank.

14. Do you envisage any currencies other than the dollar assuming larger roles as intervention currencies over time? If so, which and why?

Respondents' answers

A few respondents foresaw the Deutschemark acquiring a more important role as an intervention currency within the EMS and three central banks, of which one was from South-East Asia, said that the yen could "conceivably" play a more active role in the trade and payments of Asian countries. However, central bankers agreed that the dollar would remain the dominant intervention currency. One G-10 central bank envisaged the possibility of a convergence of the "nth-currency dollar system" and the "multi-intervention EMS", as suggested by occasional reference to a "common dollar policy" within the EMS. (In its view, such a policy would require the cooperation of the US monetary authorities). This bank added a caveat:

"Multiple currency intervention risks being indeterminate in its effects on exchange rates unless subject to well-defined rules as in the EMS. We see obstacles to its more general application outside closely-knit arrangements for coordination in other areas of policy such as attempted within the European Community".

Apart from the reasons usually given for the dominant role of the dollar as an intervention currency (the role of the dollar in the currency markets, its ready availability and the size and breadth of the US markets) one bank noted that accumulation of reserves in other currencies was limited by "the necessity to secure the prior permission of the issuing authority".

Another stated that over time, as diversification proceeds, the distinction between an intervention currency and a reserve asset could fall away: "Certainly the Deutschemark could become more generally used, particularly if the US were to revert to market intervention."

15. What growth do you foresse in the role of the ECU
    a) as a reserve asset
    b) in private transactions?

Respondents' answers

Central banks from outside the EC did not show much interest in the future of the ECU and several did not answer the question. Banks from EC member countries said they saw the "potential" for growth and focused their answers on the changes that would, in their view, be required for the ECU to become a fully-fledged reserve asset. One emphasized that it had to become a means of payment. Typical of other replies is this one, quoted in full:

"We see a potential for growth of the ECU both as a reserve asset and in private sector transactions paralleling the further development of the EMS as a 'zone of monetary stability' (comprising exchange rates as well as prices and domestic monetary conditions). However, such growth will be conditional on the characteristics and qualities of the ECU as a denominator of financial claims and liabilities; these characteristics may have to be improved on, including the rules governing changes in the currency composition, its convertibility into reserves useable outside the EMS (dollars) etc. The future of the ECU will also depend on the status of the European Monetary Fund which has yet to be created as part of the move into the institutional phase of the EMS".

16. What is your present attitude towards the "substitution account" proposed in 1979-80, that is, a substitution of SDR claims on the International Monetary Fund for some of the dollar claims on the United States represented by foreign official reserve holdings? What are the main factors influencing your attitude towards this proposal?

Respondents' answers

Most central banks began their replies by indicating that they were in principle in favor of a substitution account — or thought that interest in the idea would revive — but devoted the rest of their replies to pointing out the theoretical and practical difficulties of the 1979-80 proposal, often saying also that the renewed strength of the dollar made it less urgent to reconsider the question. It seems clear from the replies that any new scheme would have to be significantly different from the 1979-80 proposal to stand a chance of acceptance.

Two G-10 banks were openly hostile, and others skeptical. One said that such an account "could conceivably add to incentives for shifting among alternative reserve assets" and "tend to impede the adjustment process" by reducing pressure on countries to correct an underlying disequilibrium in their economies. Another G-10 central bank said that if dollar creation was excessive "substitution of dollars would be tantamount to a balance of payments support facility for the United States". Two others said that because of the volatile interest and exchange rate movements caused by varying national monetary policies, a substitution account could play a marginal role. This and another large G-10 central bank indicated that such an account might not be limited to dollars — it could lead to calls for comparable facilities for other currencies — though one of these respondents seemed to regard this as a problem and the other as an opportunity.

The major technical problem mentioned in many replies related to the bearing of the exchange risk and "amortization". At a practical level, one leading central bank doubted whether large amounts of dollar claims (or other currencies) could be "mobilized to be demobilized" in a substitution account, at least while the dollar was expected to remain strong.

Developing countries, including oil producers, were generally more favorably disposed. They too, however, had far-reaching criticisms of the 1979-80 scheme. Among these were that it did not provide for inclusion of private holdings, it did not create SDRs but only SDR-denominated claims; that participants' commitments might extend to direct financial support and that the availability of funds in the Euromarkets might be affected.

17. What role do you envisage being played by gold
    a) In the international monetary system?
    b) In central banks' reserve policy?
    c) For domestic monetary purposes?

Respondents' answers

Respondents were unanimous in saying that they can envisage no role for gold in the international monetary system or in domestic monetary systems at any forseeable time and only a very limited role, if any, for gold in central banks' reserve policy.

The view was put brutally by the central bank of one of the G-10 countries which had had the reputation of a strong attachment to gold in the 1960s. It said, "We do not believe that a return to some form of gold standard is either desirable or feasible. Gold will, in our opinion, simply continue to play the role of a residual component in central bank portfolios".

Another G-10 central bank, among the world's top half-dozen in its holding of gold reserves, said: "We do not believe that a revival of the gold standard is desirable or, indeed, feasible. We do not believe, in particular, that the objectives of external and internal stability would be served by anchoring the international monetary system to an exogenous standard's arbitrary quantity and price, nor that the latter magnitudes could be adequately controlled to ensure the desired growth of international liquidity and international adjustment". As to gold in national reserves, it added: "The main problem is how to mobilize gold in case of need without affecting the private markets". In that connection, some respondents referred to gold in central bank vaults as "crisis" reserves or "war chest" reserves.

Some European central banks noted that the European Monetary System had begun to provide at least a limited role for gold in official transactions. One of these pointed out that in the EMS, 20 per cent of gold serves as a counterpart of ECU creation, resulting in partial mobilization of gold for indirect use in settlements within the EMS, albeit it on a provisional basis and without any permanent transfer of gold taking place.

18. It has sometimes been argued that a multiple currency reserve system may have some advantages — e.g. that it spreads responsibility for managing the system to a wider group of countries — that compensate for its alleged disadvantages. What in your opinion are the main benefits or drawbacks of a MCRS?

Do you share the view that a MCRS is likely to prove "inherently unstable"?

Respondents' answers

Only a small minority of respondents described the MCRS as "inherently unstable". The majority view can be summarized under three headings:

i) The MCRS is the only practical system at present and its very existence shows that it is preferable to alternatives that have failed, or which respondents have little hope of achieving;

ii) That the MCRS may contribute marginally to international instability, but far less than fundamental disequilibria in the world system and the resulting private capital flows, which are far larger than official flows;

iii) That the MCRS could or, indeed, already does contribute to some greater stability at the margin.

Under the first heading, a G-10 central bank said, "In present circumstances there is probably no alternative to the *de facto* MCRS". Another G-10 central bank commented, "If the alternative is seen as a dollar standard or a poor functioning SDR standard, the MCRS appears to offer some advantages".

Comments under the second heading included this, from a leading G-10 central bank, "Other factors making for exchange rate instability may be more relevant than the existence of the MCRS in itself, such as rapidly changing payments imbalances, varying inflation differentials and the greater variability of interest rates". Another G-10 central bank observed that "The size of private holdings of foreign exchange now so dwarfs official reserves that it needs more than an understanding about reserves to ensure stability".

Under the third heading, several respondents said an evolving MCRS does or could contribute marginally to greater exchange rate instability in the absence of greater policy coordination between the United States and the newer, secondary reserve centers. However, for that very reason, several respondents thought the MCRS might reinforce market signals imposing a quicker and more coordinated adjustment by the reserve centers.

Beyond that, about a third of the respondents saw a range of positive advantages in the MCRS. One G-10 central bank is worth quoting at length:

> "Insofar as official holders are concerned, the experience of recent years suggests that the large new holders of reserves, primarily the OPEC countries, have generally acted in a rational way, responding to market forces in the light of their own longer-term interests. Indeed, at times official flows have moved in an opposite direction to private flows. Even if official flows reinforce pressure from private flows, this may not always be inappropriate where necessary adjustments are unduly delayed."

19. What alternatives, if any, do you see to the present *de facto* MCRS in present conditions?

Respondents' answers

The overwhelming majority of respondents said they can envisage no alternative to the *de facto* MCRS in present or foreseeable circumstances. Indeed, the view that the major powers positively want the MCRS that has come into existence was put by the monetary authority of an important oil-exporting country, which said, "Since the present attitude of the majority of industrial countries is not favorable to SDR creation, it appears that the majority of the IMF's voting power is implicitly in favor of the present MCRS. Therefore, if we are to be realistic about possible developments under present circumstances, we can assume that there is no alternative to the present *de facto* MCRS".

Among the minority of respondents, a G-10 central bank urged, as an alternative to the MCRS or as an approach that would remove the reason for its existence, greater persistence in the fight against inflation internationally which would, of itself, contribute to greater exchange rate stability. Another G-10 central bank said an increased use of composite units like the SDR and ECU "could be envisaged, but cannot be achieved in the short run".

20. Is it worth considering the possibility of any sort of understanding between reserve centers and reserve holders over the pattern (and rate of change of composition) of their currency holdings — on the basis perhaps of various criteria such as trade and investment patterns? Any comment or suggestions that you would wish to make on this or other policy-related issues would be much appreciated.

Respondents' answers

More than half of the respondents said that they doubted whether any general understanding between reserve centers and holders could be achieved. Some central banks said an effort at general understanding would be "worth" making, but they did not specify how, nor did they indicate how successful they think such efforts might be.

The emphasis of other replies was on informal rather than rigid understandings, on bilateral rather than multilateral arrangements, and on flexibility.

Among the minority holding hope for some form of understanding was a G-10 central bank which said, "It is possible to contemplate some sort of arrangement between reserve centers and reserve holders on a more general basis, as opposed to more limited and temporary schemes involving a particular currency at a particular time*. In practice, such an arrangement would probably center on the G-10 and Switzerland and possibly include one or two other countries meeting regularly at the Bank for International Settlements in Basle. These are not, however, the central banks whose behavior has been most disruptive in the past".

A G-10 central bank outside the European area made the following comment: "It is conceivable that circumstances could develop where some sort of understanding between one or more reserve centers and reserve holders might be desirable, as was the case in the past with sterling balances. However, the issue of coordination of policy is much broader in scope than the question of changes in the composition of reserve holdings. The mechanism in place for multilateral consultation on policy issues and for monitoring developments appear to be broadly adequate and may be supplemented through bilateral discussions. These mechanisms have proved capable of providing the basis for arriving at pragmatic arrangements when circumstances warranted".

---

* Special arrangements of the kind referred to here were at one time made with official sterling holders.

Among the doubters, a G-10 central bank said, "We fear that the same problems that have been instrumental in not bringing about the orderly system envisaged at the time of the inception of the SDR will also hamper efforts directed at bringing more order into the MCRS". Another G-10 central bank commented, "Agreements are likely to prove difficult to achieve as long as common interests are not more clearly perceived. Reserve holders would probably be prepared to see their freedom of choice reduced only if reserve centers offered guarantees with respect to the exchange value and convertibility of their holdings. Private holders would probably not be much influenced by official agreements anyhow".

And, more tersely from the monetary authority of an important oil-exporting country, any arrangement or arrangements "would involve great efforts in terms of financial diplomacy".

STATISTICAL APPENDIX

The extent of the shift to a multiple reserve and asset currency system is difficult to measure precisely, because of imperfections in the data available. Some countries do not fully disclose their reserve holdings to international agencies. There are, moreover, difficulties in reconciling the data published by the International Monetary Fund on the foreign exchange reserves of its member countries and the estimates published by the Bank for International Settlements on liabilities to other countries reported by the commercial banking system. This reflects in part, but only in part, the fact that many countries hold foreign exchange not only in the form of official reserves on the books of their central banks, but that they also have foreign exchange assets owned by other official agencies. The latter, often less reported even than official reserves, may not be as readily mobilized as reserves held by central banks, but they are nevertheless foreign exchange assets and may be called quasi-reserves or secondary reserves. If reserves and other foreign exchange holdings could be taken into account, it is possible that official currency diversification may have been greater, at least periodically, than shown by the imperfect statistics.

However, for all those reservations, the admittedly imperfect and provisional data so far made available to the Group of Thirty are, at least, consistent. Tables 1 and 2 show a trend, while Table 3 captures a moment in time.

The tables confirm that diversification has so far been far more pronounced on the part of non-industrial countries, thus bringing out the difference between central banks which hold reserves mainly for intervention on the exchanges and others which hold varying portions of their reserves as asset portfolios. Movements in the proportion of global reserves held in dollars also depend on whether those countries gaining reserves are 'diversifiers' or not. The level and rate of increase of reserves (as compared with past experience and expected 'needs') also appears to be a factor. This is shown clearly in Table 2. The proportion of dollars in the reserves of non-industrial countries rose at the start of the 1972/73 commodities' boom and again after the first large increase in oil prices in 1973. In each case it seems to have taken time before new dollar receipts were diversified.

TABLE 1

Composition of foreign exchange reserves

Industrial countries

Currency equivalents of SDR values

per cent

End of:	$	Pound	DM	Yen	Swiss fr	Effective $ Exchange Rate
1970	85	5	2	0	1	100
1971	82*	4	2	0	1	97
1972	86*	4	3	0	1	90
1973	86	3*	3	0*	1	83
1974	87	2*	3	0*	1	85
1975	88	1*	4	0*	1	84
1976	84	1*	3	0	1	88
1977	89*	1*	4	0	1	88
1978	86*	1	6	0	1	80
1979	84	1*	6*	2*	3	79
1980	79	1	11*	2*	3*	79
1981**	79	1	11*	2	2	83

* Years in which countries marked ran current deficits.

** 1st quarter

Calculations based on preliminary IMF data. The dollar component of ECU holdings has been shifted to the dollar column and the gold content of ECU holdings has been eliminated.

NB. Real $ interest rates were negative from 1972 to 1977 and nominal until early 1980.

TABLE 2

Composition of foreign exchange reserves

Non-Industrial countries

Currency equivalents of SDR values

per cent

	$	Pound	DM	French Franc	Yen	Swiss Franc	Dutch Gulden	Effective $ Exchange Rate
1970	57	20	2	3	0	0	0*	100
1971	42*	18	5	4	0	1	0*	97
1972	55*	12	14	5	0	2	0	90
1973	47	9*	25	5*	0*	4	1	83
1974	67	11*	10	2*	0*	2	1	85
1975	70	7*	9	2*	1*	2	1	84
1976	73	3*	10	2*	2	2	1	88
1977	69*	3*	12	2*	2	3	1	88
1978	61*	3	14	2	4	3	1	80
1979	62	3*	16*	2	4*	3	1*	79
1980	58	5	15*	2*	5*	5*	1*	79
1981**	59	5	15*	2*	5	5	1*	83

* Years in which countries marked ran current deficits.

** 1st quarter

Calculations based on preliminary IMF data.

NB. Real $ interest rates were negative from 1972 to 1977 and nominal until early 1980.

TABLE 3

Composition of foreign exchange reserves by country groups

1st quarter, 1980
per cent

	Industrial Countries		Oil Exporters	Non-Oil LDCs
	EMS	Other		
Dollar	90	83	67	68
Pound	0	1	3	6
DM	6	9	17	18
French franc	0	0	2	2
Yen	0	4	5	4
Swiss franc	3	3	5	2
Dutch gulden	1	0	1	0

Source: George M. von Furstenberg, IMF Survey, January 26, 1981, p. 28.

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Address inquires to:

The Group of Thirty
Two World Trade Center
Suite 9630
New York, New York 10048
Tel: 212-775-9160

Group of Thirty

The Group of Thirty was established in December 1978, to explore basic problems in the functioning of the international economic system. It meets twice a year, for two to three days at a time. Between these meetings, study groups and researchers gather material to serve as a basis for the Group's discussions.

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Group of Thirty

How Bankers See the World Financial Market

A survey by the Office of the Group of Thirty
on behalf of the
International Banking study group

Geoffrey L. Bell
John G. Heimann
Peter Cooke
Otmar Emminger
Rainer Gut
Leland S. Prussia
Edmond Safra
Henry Wallich
Dennis Weatherstone
Malcolm Wilcox

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How Bankers See the World Financial Market

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How Bankers See The World Financial Market

Preface

Are the risks in international banking increasing? How do banks seek to protect themselves against such risks? What view do bankers take of the activities of bank supervisors? These are among the questions addressed by bankers themselves in the following survey.

The survey has grown out of the Group of Thirty's continuing work on international banking, which complements the Group's other work on exchange rates, the flow of finance to developing countries, the reserve management policies of central banks and the energy markets, among other subjects (a list of current publications is given on the inside of the back cover). Because of the crucial role played by the international banking system in many of the central issues facing the international monetary system, the Group of Thirty decided in mid-1980 to set up a special study group to monitor developments in the international money and capital markets. The study group meetings are attended by present and recently-retired central bankers and supervisors, as well as practicing commercial and investment bankers. At an early stage in its deliberations, the study group decided to solicit the views of a wider group of bankers on a number of policy issues with this objective, and to try to gain more information about banks' international activities. It commissioned the Office of the Group of Thirty to draw up a questionnaire and conduct a survey of banks. This publication is the result of that exercise. It should be read, however, in conjunction with the study group's own report, published under the title *Risks In International Bank Lending*. The survey throws light on the practices, views and concerns of commercial and investment bankers; the study group report evaluates these results, places them in a wider context, and makes a number of recommendations addressed to bankers and banking authorities.

The questionnaire was distributed to some 200 banks late in 1981. By February of this year, 111 banks had replied. Their answers were coded and processed by computer, and the resulting tabulations are given in the statistical analysis at the end of this report. The report on the answers, which draws also on interviews conducted with 30 banks, forms the text of the report, starting on page 7. The introduction summarizes the results.

Of the 111 banks responding, 29 have headquarters in North America (of which 22 are from the United States), 55 have headquarters in Europe, and the remaining 27 include banks from countries outside these regions as well as 9 consortium banks, mostly based in London. Many of the banks are quite large, with 68 appearing on a list of the top 250 world wide. Nearly all of them are very active in international markets. About 50 per cent of the banks report that their international loans account for more than 25 per cent of their total loans, while more than 80 per cent report that their international assets and earnings have grown faster in the last five years than their domestic assets and earnings. Furthermore, 80 per cent expect that trend in assets and earnings to continue.

As in previous surveys conducted by the Group of Thirty, respondents were promised absolute confidentiality; answers were seen by the staff of the Group of Thirty alone.

The Group of Thirty owes a deep debt of gratitude to the banks that responded to the survey; the willingness of the senior management of so many banks to complete a lengthy questionnaire (51 questions over 16 closely-typed pages) is itself striking evidence of the seriousness with which this subject is treated by the international financial community. The Office of the Group also wishes to thank Ms. Judith Walter, Mr. Chuck Muckenfuss and Mr. Steven Weiss for their expert assistance in preparing the questionnaire; Professor Peter B. Kenen, who gave invaluable advice on coding and processing the results; and Mr. M.S. Mendelsohn, who took the leading role in writing the report, ably assisted by Ms. Sheerin Ardalan and Ann Tutwiler. As usual, final responsibility for the contents, and for any inaccuracies that remain, rests with the undersigned.

Robert Pringle
Executive Director
Group of Thirty

May, 1982

How Bankers See The World Financial Market

Introduction

This report, like an earlier study,[1] is based on the view which bankers themselves take of the modern international capital market. But it goes further in being far more comprehensive. It is based on answers given by 111 commercial, investment and consortium banks in 30 countries of the industrial and developing worlds to 51 questions, many of them multiple questions. That is more than double the number of questions and responses on which the earlier report was based. There is more emphasis this time on the attitude of bankers not only to their market, but also towards official regulation, the competence of supervisors and the competence of the authorities. Above all, the present study contains a far more extensive statistical analysis of bankers' answers, processed by computer and designed to allow readers to form their own conclusions.

The broad picture which emerges from this study is that a majority of bankers expect their international lending and earnings to go on growing faster than their other business in the coming five years although less rapidly, perhaps, than in the past five. At the same time, however, bankers are becoming somewhat more concerned about the international market and the ability of the authorities to act promptly in case of need. And, while this study concentrates on international banking risks, it is impossible to divorce those from domestic banking risks. In interviews, several bankers referred to the increasing pressure on corporate balance sheets and a growing number of company bankruptcies in Western countries. A further deterioration in this respect could pose a serious challenge to the banking system if it coincided with more reschedulings of cross-border loans.

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[1] "The Outlook for International Bank Lending," Group of Thirty, August, 1981.

Such concerns have to be taken seriously, but should also be put into perspective. Bankers need to be cautious by the very nature of their business as custodians of other people's money. "Concern" on a banker's part is not, therefore, always synonymous with "worry". That is why many questions have been broken down to ask respondents to rate the degree of their concerns, as best they can, as being "serious," "moderate" or "minor." Moreover, the answers to several questions show that banks are taking greater precautions in the international market, especially in their evaluation of borrowers and in their assessment of other banks with which they place funds in the Euromarkets.

Similarly, when bankers say that the system would be "vulnerable" to a certain risk — for example, "vulnerable" to a "chain collapse" of the banking system in the event of a crisis affecting a significant bank or group of banks — this does not mean that they consider such an eventuality to be likely. Indeed, in the example quoted above their supplementary comments made clear that they consider it most improbable.

While this study concentrates on bankers' views, their answers provide, also, some important new factual information. The very active extent of trading in the international interbank market (the Euromarket) is statistically shown in the answers to Question 44. Another arresting development is the new priority which banks give to political trends, following events in Iran, Poland and elsewhere.

Principal Results

Some of the main conclusions that emerge from the study are:

Prospects for International Lending and Earnings

- About 75 percent of respondents expect their international lending and earnings to go on growing faster than other business in the next five years, but only a quarter expect a "substantial" increase compared with half which actually experienced such an increase in the past five years (3 and 4);[2]
- About 75 percent said international lending in the past five years had proved as profitable or more profitable than domestic lending (5);
- More than 40 percent of respondents think international lending risks will increase "substantially" in the next five years, compared with 25 percent who said the risks had increased "substantially" in the past five years (6);

Country Risk and Reschedulings

- The main threats to individual banks were listed in the following order: default by a major borrowing country; large numbers and amounts of reschedulings; foreign exchange losses; losses from mismatching of maturities and currencies (7).
- Large numbers and amount of reschedulings were seen as the main threat to the international banking system;

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[2] Numbers in brackets refer to the questions and the tables in the Statistical Section.

- More than 90 percent of banks said they had increased the resources devoted to country risk analysis in recent years (22);
- Banks now give political analysis priority even over economic analysis in their assessment of country risk (31);
- Both in international lending and in placing funds in the international interbank market, most banks say they rely on their own judgment above all others (like analyses from international institutions, the views of other banks or reports from outside consultants) (26, 32, 49);
- Nearly all banks have centralized systems for reviewing country lending limits and about two-thirds set limits by maturity as well as amount (deciding, for instance, that only a part of the total approved be lent at, say, more than one year) (30);
- A majority of banks believe that more cofinancings with official institutions might help reduce the system's risks (33);
- More than half of the respondents think the indirect costs of reschedulings could become a "significant" concern in the future. At the same time, more than half are unsure whether existing rescheduling arrangements are satisfactory and nearly 20 percent believe they are not (34 and 36);

The Interbank Market

- A new breakdown shows extremely active trading in the international interbank market (or Euromarket). Half of all respondents say they regularly redeposit with other banks more than 40 percent of funds obtained in the market and a quarter of the respondents normally redeposit more than 60 percent (44);
- About half the respondents think that interbank activity is becoming more risky as a result of the change of composition of participants. However, about the same proportion deny that interbank trading is "excessive"; a minority believes it to be "excessive" at some, mostly smaller banks; less than 10 percent of respondents describe it as "excessive" for the system as a whole (45);
- Nearly all banks say that they set overall and daily limits on interbank placements. Mostly limits are set on an assessment of the bank with which the funds are to be placed as well as an assessment of that bank's country of origin (47);

Banking Supervision and Crisis Management

- A majority of American banks (and a minority of European and other banks) complain of burdensome regulations which could be modified or dropped without impairing prudential control (12);
- American bankers feel more strongly than any other group that regulation by their authorities puts them at a disadvantage in international competition (8);
- Capital requirements were mentioned most often as imposing a competitive disadvantage (9);
- The change in regulation most desired by a majority of respondents is "harmonization" in the major financial centers to reduce the market distortions which they say result from differences between national regulations and supervision practices (16);
- About 60 percent state that the system would be vulnerable to a "chain collapse" in the event of a crisis affecting a significant bank or group of banks (21);
- Nearly 80 percent of respondents think the authorities should give sup-

port in a liquidity but not a solvency crisis. However, 60 percent believe it is not feasible to distinguish between the two in an emergency (20);

- About three-quarters of the respondents believe there is need for clearer understanding about lender-of-last-resort facilities for distressed banks (21).

How Bankers See The World Financial Market

Report on banks' answers to the questionnaire

1. THE INTERNATIONAL BANK LOAN MARKET

International lending and earnings

More than 40 percent of the banks in this survey think international lending risks will increase "substantially" in the five years to 1986 (6).* Nevertheless, a quarter of the respondents expect a "substantial" relative increase in their international business in the five years ahead; this compares with almost half which reported having experienced a "substantial" increase in the past five years (3 and 4). More than 75 percent anticipate that there will be some relative growth in their international lending and earnings.

The expectation of continuing growth is explained partly by the wide range of services which banks consider as "significant" aspects of their international operations (1).

Profitability

The relative profitability of international lending in the past five years emerges from answers to Question 5. About three-quarters of all respondents said it has been as profitable or more profitable than domestic lending. However, answers differed considerably between regions. International lending was reported to have been relatively more profitable by over 70 percent of respondents from Asia, the Middle East and Latin America, but by 55 percent of those from North America and a third of those from Europe.

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* Numbers in brackets refer to tables in the Statistical Section. They do *not* refer to the summary tables in this text.

Summary Table 1

International Lending and Earnings*

Changes in International Lending and Earnings in Relation to Total Lending and Earnings

All Respondents (percent)

	Past Five Years		Next Five Years	
	Lending	Earnings	Lending	Earnings
"Substantial" increase	46	42	22	22
"Some" increase	33	36	54	54
	79	78	76	76

* Percentages have been adjusted to exclude non-respondents.
Derived from table 6 in Statistical Section.

In addition to average spreads on loans, the most profitable aspect of international lending is other banking business kept or gained with the borrower and third parties (19). In this respect, there was no significant difference between the answers of all respondents and those of the world's 100 biggest banks among them.

Summary Table 2

Profit Factors Ranked

(Factors in Addition to Average Spreads)

All Respondents (percent)

	"Very Important"
Other business with borrower	47
Ditto with third parties	12
	59
Fees	57
Cost of funds below Libor	24

Total do not add to 100 because banks listed several factors as "very important."
Derived from Table 19 in Statistical Section.

Spreads

Nearly 80 percent of all respondents singled out supply and demand as the most important influence on international lending spreads (17). The second most important influence cited was aggressive pricing by lenders seeking to enter new markets, as one of the manifestations of supply and demand. However, aggressive pricing by banks enjoying special regulatory advantages was also mentioned as an influence on spreads and, while the first two influences mentioned above result from the operation of market forces, the third reflects a distortion of those forces.

It follows logically that in their answers to Question 18, bankers were almost unanimous in saying that lending spreads could be improved only by changes in the demand for and supply of funds. The consensus was that a change in supply and demand could be brought about either by changes in world economic trends or, less happily, by some political or economic upset. A minority of respondents suggested that the imposition of higher capital and liquidity ratios on a harmonized basis might help force lenders to seek higher margins, but were skeptical that this could be achieved. One bank asked, "Why interfere with well functioning markets?" and another simply dismissed the notion of spreads at any level as being "too narrow."

International Lending Risks

More than 40 percent of all respondents think international lending risks will increase "substantially" in the next five years compared with about 25 percent who said they had increased "substantially" in the past five years. However, the world's biggest banks are somewhat more optimistic and North American banks considerably more so (6).

Default by a major borrowing country, large numbers and amounts of reschedulings, foreign exchange losses and mismatching of maturities and currencies were listed in that order as the most important threats to banks. Defaults, reschedulings, funding problems and abrupt government action, like new controls, were listed as the most important threats to the system (7).

On average, 25 percent of the respondents described these threats to the individual bank as "serious." The others described them as "moderate" or "minor" threats. Threats to the system (among those listed in this question) were described as "serious" by a smaller proportion of banks.

Country Risk Assessment

More than 90 percent of the respondents said they had increased resources dedicated to country risk analysis in recent years. Most of them said they had done so by concentrating risk analysis at headquarters,

Summary Table 3

Lending Risks in Five Years to 1986 (percent)

	All Respondents	Biggest Banks	North America	Europe	Other†
"Substantial" increase	41	39	24	47	44
"Modest" increase	49	56	55	46	56
No change or decrease	10	5	21	7	0

Derived from Table 6 in Statistical Section.
† Asia, Latin America and the Middle East

Summary Table 4

Threats Ranked

Respondents (percent)

"Serious" Threats* to:	Banks	The System
Default by major country	33	16
Large reschedulings	28	18
Forex losses	23	2
Maturity mismatching	22	5
Unavailability of interbank funds	20	13

* These threats were described as "moderate" or "minor" by the other respondents. Derived from Table 7 in Statistical Section.

recruiting specialist staff and consultants, by gathering more data and by trying to analyze information in a more sophisticated way (22).

A majority of respondents said that their analysis of political and social conditions carried the greatest weight in their assessment of country risk, followed by quantitative analysis of economic data. Key economic forecasts carry less weight (31). The priority given to political analysis is recent at many banks following the experience of Iran, Poland and other countries.

The most important fact emerging from answers to Question 32 (and also Questions 26 and 49) is that banks prefer to rely on themselves in gathering information and forming their views. Analyses of economic, social and political trends prepared by the banks' own staffs were cited as the most important aspect of risk assessment by more than 75 percent of all respondents, and reports by bank staff residing in or visiting foreign countries were listed next. Less importance was attached to the analyses of international institutions, the assessments of other banks and reports from outside consultants.

Summary Table 5

Factors of Country Risk

Factors* Ranked as "Very Important"	**By Percent of All Respondents†**
Political and social conditions	83
Economic data	80
Judgment of country specialists	64
Key economic forecasts	51
Involvement of other banks	15

† Percentages do not add to 100 because banks listed several factors.

* Factors above were described as "moderately" important or "not important" by other respondents.

Derived from Table 31 in Statistical Section.

The point is driven home in answers to Question 26: nearly 90 percent of all respondents said they think it inappropriate for banks to rely on country risk assessments by other banks instead of their own, although more than a third of the smaller banks questioned took the opposite view.

Decisions on country limits are centralized at almost three-quarters of all respondent banks (29). Such limits are set both by amount and maturity by more than two-thirds of North American and European banks in the sample (30). However, less than half of the respondents from other regions set maturity limits and a majority of all respondents do not have separate limits for classes of borrowers within the overall country limits they have established for themselves (30).

Summary Table 6

Maturity Limits

Banks Which Set Maturity as Well as Country Limits*

Percent of:	All Respondents	North America	Europe	Other†
	63	68	67	44

* These are banks that set country lending limits by amount but also decide that only a part of the total shall be lent at, typically, more than one year.

† Asia, Latin America and Middle East.

Derived from Table 30 in Statistical Section.

Confinancing

Political pressures and the lender's trap are two factors that can affect lending decisions — possibly inducing banks to exceed country lending limits they have set themselves. About 75 percent of all respondents say they do not believe such pressures have significantly affected foreign lending by their own countries' banks; which nevertheless leaves a reasonable minority that believes the opposite (23). Similarly, about three-quarters of all respondents believe that the weight of outstanding loans and commitments have not influenced banks to extend still further credits beyond levels of normal prudence (24a). Nor do most of them think that this might become a serious danger in future (24b).

However, while banks prefer to rely heavily on their own judgment (32) and are not unduly troubled by pressures that might override their judgment (24), most of them would welcome some forms of official help or cooperation. That emerges by implication from the answers to Question 33. A majority believes that confinancings with official institutions, an IMF country-rating system and credit insurance schemes might be helpful, in that order, in reducing the system's risks.

Maturity mismatching in the bank loan market

More than 20 percent of the banks surveyed cited maturity mismatching as a possibly "significant" threat to banks (7). However, their answers to subsequent questions do not make wholly clear the extent to which they themselves have taken new precautions against such a threat. A partial explanation may be the tendency to attribute imprudence to other banks rather than one's own.

More than half the banks polled said that the greater volatility of interest and exchange rates had *not* caused them to change their maturity (gapping) and currency mismatching practices in the Euromarkets (37). Two banks said they had not changed because they had always matched currencies and maturities. Most of the others offered no explanation. Those banks which said they had changed their practices were more forthcoming. Among the changes listed were the imposition of new limits on open positions; increased recourse to floating rate instruments on both the asset and liability side; a "significant" reduction in interbank placements; and more stringent controls generally. The latter may be partly reflected in the fact that more than 90 percent of all respondents control or monitor funding operations from their head offices (38).

Respondents were almost unanimous in saying that a relatively cautious funding approach is appropriate for smaller banks and newcomers to the market, but a majority even of smaller banks added that their practices were in fact no different from those of bigger banks (40). However, as one respondent noted, this did not necessarily mean that smaller banks are "less prudent" than bigger ones.

Asked to rate the performance of central banks in monitoring mismatching about one-half of all respondents viewed it as excellent or good leaving another half which called it no better than fair or poor, or gave no answer.

Summary Table 7

Monitoring Maturity Mismatching

Supervisors' Performance in Monitoring Mismatching
Respondents (percent)

Performance	North America	Europe	Others	All
Excellent/good	54	47	44	47
Fair/poor/no view	46	53	56	53

Derived from Table 39 in Statistical Section

Geographic Deposit Concentration

More than 60 percent of all respondents monitor geographic concentration of deposits, and 25 percent have sometimes turned away large deposits, to avoid excessive geographic concentration (41 and 42).

To monitor the geographic concentration of deposits is not the same as being troubled by such concentration. "We monitor, but do not attempt to control" was the comment of one bank.

Many banks interviewed said that geographic concentration did not in fact worry them. This is particularly true of large banks, to which geographically concentrated deposits tend to flow. That is why a larger proportion of bigger than smaller banks monitor such concentrations.

An attitude emerging from written comments and interviews is that many banks are not troubled by geographic concentration of deposits as such. They are concerned either when they believe such deposits may be unduly volatile or when offered large deposits (from any source) for which they do not have immediate, profitable employment.

The refusal of large deposits is either by price or by a frank explanation of the reasons. On impressionistic evidence, the latter approach is becoming more common because it helps to maintain relations with the prospective depositor over the longer term. Some banks admit, however, that they sometimes accept unwanted deposits "reluctantly" for the sake of not disturbing customer relations. The attitude of banks is mirrored by that of supervisors; almost two-thirds of all respondents said their home supervisors do not monitor geographic deposit concentrations, although the degree of such monitoring is higher in North America than elsewhere (43).

Rescheduling

More than half of the respondents think the indirect costs of reschedulings could become a "significant" concern in the future (36). Answering another question, more than half said they are unsure whether existing rescheduling arrangements would be able to tide over the system in the event of more frequent and larger reschedulings; 17 percent think present arrangements would not suffice; nearly 30 percent think that they would prove adequate (34).

Only a minority of bankers have changed their policies and practices on the experience of rescheduling so far (35). Most of these have done so by exercising greater care about new lending. None, in written comments and interviews, reported any significant changes in the procedures they adopt in reschedulings. Indeed, many banks expressed a preference for the present *ad hoc* approach because in their view reschedulings vary greatly, case by case.

A large European bank said it preferred the existing untidiness which allowed it to move ahead of its rivals to recoup as much as possible at the first hint of difficulties in a borrowing country. "Our duty to our depositors and shareholders comes first" it said. The admission was unique, although the practice may not be. However, consideration for the continuity of relations between banks suggests limits to the spread of this approach.

2. INTERNATIONAL INTERBANK MARKET (EUROMARKET)

A series of questions concentrated on the international interbank market, which banks use extensively to help fund their medium- and longer-term cross-border lending.

The extremely active nature of the international interbank or Euromarket is shown by the fact that half of all banks surveyed normally redeposit with other banks more than 40 percent of the funds they have obtained in the market (44). The proportion varies from almost 60 percent at the world's 100 biggest banks among the respondents to 40 percent at the "medium sized" (ranked from 251 to 500 in the world league). But it is higher at the smaller banks in the sample (those outside the world's top 500), suggesting that some of these trade very actively in relation to their size. Although banks were asked what proportion of funds taken they *normally* redeposit in the market, several pointed out that the position fluctuates considerably. To that extent the answers in Table 44 and the summary table below represent a snapshot of a moment in time, towards the end of 1981.

Summary Table 8

Interbank Activity

Proportion of Interbank Funds Normally Redeposited
Respondents (percent)

	Largest	Large	Midsized	Smaller	All
Redeposits of 40 percent upwards	59	46	41	50	51
Redeposits of 60 percent upwards	26	25	22	36	26

Derived from Table 44 in the Statistical Section.

In spite of very active interbank trading, less than 10 percent of respondents think it "excessive" for the system. Nearly half said that it is not and about a third said that it is or may be "excessive" at some banks (45). The response to this question, at 68 percent, was the lowest to any of the questions asked, which may be explained by the comment of some banks that they could not define "excessive" and that there were no data from which the extent of "excessive" trading could be determined, however defined.

Summary Table 9

Is Interbank Trading "Excessive"?

Respondents (percent)*

Yes for System	No for System	Yes for Some Banks	No View
9	48	31	12

* 68% response.
Derived from Table 45 in Statistical Section.

Among those that said trading was not excessive, one bank commented, "Interbank trading provides liquidity and is a healthy facility for the advancement of world trade and commerce." Another comment was that the interbank market provides "a necessary facility for liquidity and maturity matching." The opposite view was put by a bank which said, "Interbank activity has expanded to levels which now represent considerable potential risks." Most of those respondents who said that there was over-trading at some banks alleged that this tended to occur at smaller banks and at some consortium banks. However, they pointed out that consortium banks could to some extent rely on the resources of their parents as well as their own.

Interbank Credit Rating and Limits

Nearly all banks say they set overall and daily limits on interbank placements (47). In most cases, limits are set on an evaluation of the bank with which funds are placed and that bank's country of origin (47).

When assessing the creditworthiness of other banks in the interbank market, banks prefer to rely on themselves (49) just as they do in assessing country risk (32 and 26). The answers to Question 49 show that in assessing other banks, banks rely mainly on financial analyses prepared by their own staffs and on reports from their own staff who have visited the bank being evaluated. Far less importance is attached to advice from correspondent banks except, understandably, in the case of smaller banks with their limited resources. Reports from outside services are not regarded as very important by any group of banks in this survey.

Nearly all banks say that consideration of country risk plays a "significant role" in influencing decisions on interbank placements and two-thirds evaluate the willingness and capacity of foreign banks' authorities to support those banks in adversity (50).

Official monitoring of interbank activity is most widespread in the North American region, but less so in other regions covered, namely Europe, Asia, Latin America and the Middle East (51).

Most banks have lists of other banks with whom they are prepared to deal in the interbank market (48). The lists are described as "short" by some banks, but are "comprehensive" at others, including one bank which says that it deals with about 700 other banks. Nearly all respondents say that they regularly review both the lists of banks with which they deal and also the limits set for each bank. Some banks confine their dealings mainly to the world's biggest banks and banks in countries with negligible political risk (mostly OECD countries). One bank having this approach says that deposits placed with banks in other countries are treated as "lending" and examined within country limits. Another bank said it evaluates all its interbank placements as "loans." Approaches vary in detail. One bank said it placed interbank funds only with banks with which lines of credit had been formally established. Some said that while confining themselves to the largest and most highly regarded banks, they made "numerous" exceptions, and one bank said simply "We deal with those we trust."

3. BANKING SUPERVISION

A large part of the questionnaire was devoted to bank supervision. Some of the answers are quite striking.

Banks were asked whether the supervision of international lending is more or less burdensome in their own countries than in the countries of their principal competitors (8). Here is a distribution of replies:

Summary Table 10

Burden of Supervision

	All	North America	Europe	Other
More burdensome	33	50	29	28
Roughly the same	47	36	56	39
Less burdensome	20	14	15	33

99% response
Derived from Table 8 in the Statistical Section.

It is perhaps scarcely surprising that bankers tend to feel that the supervision applied to them is often more burdensome than that applied to their competitors. What is striking is the extent to which North American bankers feel discriminated against in this sense, and the extent to which bankers from outside North America and Europe acknowledge the less burdensome nature of their home supervisory requirements. Further analysis revealed that, among individual countries, U.K. banks tended to regard their supervision as "less burdensome"; Japanese banks regarded their supervision as "more burdensome", as did U.S. banks.

A large majority of all groups of banks thought that differences in regulatory requirements were important compared to other factors affecting banks' relative competitive advantages (10). U.S. banks seemed to feel more strongly than most others about this. U.K. banks, by contrast, did not in general feel regulatory differences to be very important.

Asked whether they believed that regulatory advantages enjoyed by certain banks create distortions that tend to impair the ability of "banks in general" to earn an appropriate return on international lending, again most banks from both North America and Europe said that they did and most "other" banks said that they did not (11), presumably because the latter felt they were able to make an "appropriate" return whilst enjoying regulatory advantages.

Turning to particular regulations, the banks were asked to score a number of techniques used in supervision and regulation (9):

> "In what specific respects do you believe that your bank benefits or loses in international lending competition because of regulatory and supervisory differences among countries?".

The answers throw light on the perceived differences in the burden of supervision revealed in the answers summarized above.

Overall, capital requirements were mentioned most often in imposing a competitive disadvantage. Complaints on this score were concentrated in North America and Europe (57 percent and 54 percent of the respondents respectively mentioning it as a factor). North American banks also mentioned loan size requirements (55 percent) and especially restrictions on permissible activities (78 percent) as disadvantages. These are the three main factors (among those listed) accounting for the feeling of "discrimination" among North American bankers noted above. Among European bankers, no factor other than capital requirements was mentioned by more than 50 percent of respondents. Among "other" bankers, restrictions on loan size and requirements for approval of specific transactions were mentioned as disadvantages by half the respondents.

Among the competitive advantages, North American banks cited (the

Prudential requirements and competitive advantage

Summary Table 11

Country Analysis

Requirement:	**U.S.**	**Canada**	**U.K.**	**France**	**Ger.**	**Switz.**	**Japan**
Capital requirements	Disadvantage			Advantage	Disadvantage	Disadvantage	Advantage
Reserve requirements				Advantage	Disadvantage		
Liquidity requirements		Disadvantage			Disadvantage	Disadvantage	Disadvantage
Loan size limitations	Disadvantage	Advantage	Advantage	Advantage	Advantage		Disadvantage
Country exposure limits	Disadvantage		Advantage	Advantage	Advantage	Advantage	
Reporting requirements							Disadvantage
Requirements for approval of specific transactions	Advantage	Advantage	Advantage				Disadvantage
Restrictions on permissible scope of activities	Disadvantage	Advantage	Advantage			Advantage	Disadvantage
Foreign exchange restrictions	Advantage	Advantage	Disadvantage			Advantage	
Credit controls		Advantage	Advantage			Advantage	

* Note: The classification of a particular requirement as an 'advantage' or 'disadvantage' does not imply that all respondents from the country in question replied similarly but only that a clear majority answered in the manner indicated. If there was no clear majority, no answer is recorded. Classification of a particular requirement as an "advantage" implies that no such requirement exists in the country or that its effect is comparatively less burdensome.

lack of) foreign exchange or credit controls, and requirements for approval of specific transactions. Among the advantages cited by non-American bankers, the most frequently mentioned was (the absence of) country exposure limits.

As further breakdown of the results from seven leading countries is shown in summary Table 11.

Asked whether they believed that their home country supervisors should be more sensitive to the international competitive implications of their actions and requirements on the banks they regulate, 66 percent of North American respondents but only 36 percent of Europeans and 47 percent of "other" banks replied in the affirmative (13).

In the interviews and comments, banks tended to be critical of supervisory practices. One criticized the U.S. authorities' "insistence on applying U.S. laws and regulatory standards in other countries." Another bank mentioned supervisory advantages enjoyed by foreign banks operating in the United States. Several North American banks stated that supervisors need to become more familiar with the complexities of international banking. Other U.S. banks complained that supervisors occasionally neglect the essentials by excessive concentration on minutiae. One U.S. bank went even further, saying that U.S. supervisors suffered a "knowledge gap."

Of the European bankers who complained that their supervisors did not make enough allowance for the subtleties of international banking, several, like their North American counterparts, complained of discriminatory regulations as well as antiquated requirements that do not allow for the increased importance of international banking.

Of the bankers from other regions who commented, many also complained of discrimination and a general lack of understanding by supervisors of the international banking environment. One Japanese banker called strongly not for more "sensitive intervention" but for "deregulation" (13).

In view of these comments, it is not surprising that a clear majority of North American banks, and a large minority of European and other banks, say that some burdensome regulations could be "modified, reduced, or eliminated" without seriously affecting prudential objectives (12). Interestingly, however, no British or French bank agreed.

Japanese, German and U.S. banks amplified their answer to question 12 to a greater extent than other respondents. Japanese banks mentioned factors such as: reporting requirements, and restrictions on Japanese participation in syndicated loans, on the securities business of overseas subsidiaries, and on the issuance of foreign currency bonds. Some German banks wanted the elimination of reserve requirements for non-resident deposits used to fund international loans, or a modification which would reduce the requirement to the excess of foreign liabilities over foreign assets. One German bank complained of rigorous, "perfectionist" reporting requirements. A Swiss bank specified a slight reduction in capital ratios, to the "effective British levels."

About 60 percent of North America bankers saw changes which could be made feasibly, and the overwhelming majority of these were headquartered in the United States. Among those regulations which they said could be reduced or eliminated were: the Foreign Corrupt Practices Act, recording requirements for certain investments, limitations on the ability to invest in non-banking entities and on underwriting activities, the ban on interstate banking, and "reserve requirements, capital requirements and boycott requirements."

In response to question 14, about 40 percent of all bankers said that there were supervisory changes either proposed (or recently enacted) which would (or did) affect their competitive position. Of the banks which answered yes, the North Americans seem more favorably disposed to the new changes. U.S. bankers mentioned the establishment of international banking facilities in New York and the proposed increases in the allowances for bankers acceptances. Canadian bankers commented on the recent revision of their bank act which allows foreign banks to open branches in Canada and should, in their judgment, allow Canadian banks to enter markets previously closed to them. Japanese banks were pleased by the recent liberalization of foreign exchange restrictions.

European bankers, however, tended to be less approving of recent (or upcoming) changes. German banks specified the proposed law which would require them to consolidate balance sheets and supervision of branches abroad, a change that would affect international lending operations through their subsidiaries in Luxembourg. U.K. banks mentioned proposed changes in liquidity and reserve requirements. Swiss bankers also commented on recent increases in reserve requirements. Consortium banks headquartered in London mentioned tighter control and greater supervision by the Bank of England regarding capital requirements and tougher foreign exchange limits.

In response to question 16 regarding desired changes in the international supervisory and regulatory environment nearly three fourths of all bankers called for more harmonization, two fifths wanted less supervision and about one third wanted to eliminate requirements which discriminated against international business. A majority of bankers from the United Kingdom, Germany and Switzerland wanted to see more harmonization. A significant minority of German bankers wanted to eliminate discriminatory requirements. Very few bankers from these European countries wanted to see less supervision.

The bankers from other regions were evenly divided between harmonization and less supervision, but Japanese bankers opted for less supervision.

Almost 70 percent of North American bankers and 90 percent of US bankers desired more "harmonization." Only 40 percent of North American bankers mentioned less supervision, but all of these were from the United States. Many U.S. banks called for the elimination of discriminatory requirements (16).

After all these comments, it is perhaps surprising to find that 60 percent of bankers believe that "supervisory and regulatory actions taken by (their) national authorities provide an effective, constructive influence on (their) bank's management of international banking risks" (15). But that leaves 40 percent who took the opposite view. U.S. banks split down the middle on this question. The most negative replies were those made by Swiss banks. Again, a majority say that their home supervisor's activity in country risk analysis, and monitoring country exposure is "constructive". However, it may be more significant that a large minority of bankers — roughly one third — said that supervisors' activities in these respects were ineffective or "not applicable."

4. WHEN SHOULD AUTHORITIES SUPPORT?

One of the most striking findings of this survey emerges from answers to Question 20. Nearly 80 percent of all respondents believe the authorities should provide support in the event of a liquidity but not a solvency crisis. At the same time, about 60 percent believe it is not feasible to distinguish between the two in an emergency. This doubt undermines one of the most important assumptions on which national banking systems have traditionally functioned and on which the international system is presumed indirectly to rest. In theory and usually in practice, central banks feel no obligations to save an individual bank, but they do have a duty to provide sufficient liquidity to tide over the system as a whole in the event of the failure or one bank or a group of banks. That implies by definition that the authorities are able to distinguish between a solvency and liquidity crisis. It is therefore very important for the authorities to know that a majority of leading international banks do not believe they have that ability in present circumstances.

Summary Table 12

Should the Authorities Support?

All Respondents (percent)

	In a liquidity but not solvency crisis?	Is it feasible to distinguish between the two?
Yes	79	41
No	21	59

Derived from Table 20 in the Statistical Section

The respondents' wish for greater safeguards emerges also from the answers to Question 21. More than 60 percent believe that under present arrangements, the international banking system would be vulnerable to a chain collapse in a crisis involving a major bank or a group of banks. Banks responding in their way included 73 percent of German banks and 70 percent of U.K. banks but only 45 percent of U.S. banks. In that context it is not surprising that almost three-quarters of the respondents believe there is a need for clearer understanding about lender of last resort facilities in the international market (21). Again, this included 80 percent of U.K. banks, 60 percent of Japanese banks and 55 percent of German banks; 77 percent of U.S. banks also took their view.

Almost half of the respondents believe that an international "safety net" organized by international banks themselves might be helpful for supporting individual banks in a liquidity crisis (and thus helping to contain such a crisis). The Swiss and Japanese banks were in strong agreement; U.K. and U.S. banks, however, disagreed with the proposal. There was less support for the notion that the role of lender of last resort be assumed by an existing international organization (like the IMF or the BIS) or even a new institution. Commenting on that, last, one banker wrote, "Heaven forbid!"

STATISTICAL ANALYSIS

PREFACE

The following section provides a statistical analysis of the questionnaire and is designed and presented to allow readers to draw their own conclusions from the material.

In order to carry out the statistical analysis, the 111 banks were distributed according to their size and geographic location. Ranking by size was obtained from *The Banker's* top 500 listing in the November 1981 issue. Respondents were grouped by largest (the top 100 banks), large (101—250), middle size (251-500), and smaller (those outside the 500 listed). There were 39 banks in the first group; 29 in the second; 27 in the third; and 16 in the last. This last group contains banks that do not appear in the top 500 listing, and includes nine consortium banks.

The banks were also grouped according to the geographic location of their headquarters. The three divisions are North America, Europe, and "other". Since the number of banks responding from Latin America, the Middle East and Asia, was in each case small, the "other" group consists of banks from all those regions. The North American group includes 27 banks from the United States and Canada, and two from Mexico. The European group contains 55 banks from the United Kingdom, France, Germany, Switzerland, Italy, Austria, the Netherlands, Belgium, Spain, Portugal, Sweden, Finland, Norway, Denmark, Ireland, and Yugoslavia. The category "other" includes 18 banks from Austria, New Zaland, Japan, Thailand, Hong Kong, the Philippines, India, Kuwait, United Arab Emirates, Iraq, and Brazil.

In questions 17, 19, 31, 32, and 49, bankers were asked to rank their answers on a scale of 0 to 10. Tables relating to these answers have been simpilified to read Very Important (a score of 7—10 on a scale of 1-10), Moderately Important (a score of 4-6), and Not Important (a score of less than 4).

Unless otherwise indicated, response rates were above 95%.

International Lending and Earnings

1. Significant International Activity

Which of the following aspects of international banking business are currently significant activities for your bank? (Please check the lines that apply.)

Activity	All Banks percent	Largest Banks percent
Foreign exchange	90	97
Servicing overseas needs of domestic customers	89	100
Direct lending to multinational companies	78	87
Participation in syndicated Eurocurrency loans	73	82
Lead management of Eurocurrency loans	60	77
Other special services	53	60
Investment banking	45	62
Local currency lending in overseas markets	45	72

2. Levels

Considering your bank's business on a worldwide basis, please indicate in the following chart the *approximate* ratios of (a) international earnings to total earnings and (b) international lending (i.e., loans and commitments where the exposure is outside the bank's home country, regardless of booking location or currency denomination) to total lending. (Check the approximate range that applies):

All Respondents
percent

Present Ratio of:	Less than 10%	10-25%	25-50%	Over 50%
International to total lending	16	34	34	16
International to total earnings	14	38	28	20

Largest Banks
percent

Present Ratio of:	Less than 10%	10-25%	25-50%	Over 50%
International to total lending	5	37	42	16
International to total earnings	8	39	37	16

3. Change in International Lending and Earnings

Over the past five years, how have your bank's international earnings and lending changed *relative to* total earnings and lending?

All Respondents
percent

Change, Past Five Years:	International Lending	International Earnings
Substantial relative increase	49	45
Some relative increase	35	39
No significant change	14	9
Some relative decrease	2	7
Substantial relative decrease	0	0

Largest Banks
percent

Change, Past Five Years:	International Lending	International Earnings
Substantial relative increase	51	45
Some relative increase	41	42
No significant change	8	8
Some relative decrease	0	5
Substantial relative decrease	0	0

4. Expected Changes in International Lending and Earnings

Over the *next* five years, how do you expect your bank's international lending and earnings to change relative to total earnings and lending?

All Respondents
percent

Amount of Change	International Lending	International Earnings
Substantial relative increase	23	23
Some relative increase	57	57
No significant change	19	17
Some relative decrease	1	2
Substantial relative decrease	0	1

Largest Banks
percent

Amount of Change	International Lending	International Earning
Substantial relative increase	26	20
Some relative increase	56	67
No significant change	18	10
Some relative decrease	0	3
Substantial relative decrease	0	0

5. Profitability of International v. Domestic Lending

How would you rate your bank's overall profitability (taking account of write-offs, provision for losses, and costs and income effects of restructured loans) over the last five years in international compared to domestic lending?

Regions Compared
percent

Profitability:	All	North America	Europe	Other	Consortium
Significantly better	20	34	9	28	20
Somewhat better	29	24	26	50	20
Same as domestic	27	21	33	17	40
Somewhat worse	22	21	29	5	20
Significantly worse	2	0	3	0	0

6. View of International Lending Risks

In general, how do you perceive that international lending risks have changed in the last five years?; and how do you expect international lending risks to change over the next five years?

Regions Compared

Perceived Change in Past Five Years
percent

Amount of Change	All	Largest	North America	Europe	Consortium	Other
Substantial increase	26	28	33	21	22	17
Modest increase	63	69	58	58	78	78
No change	10	3	7	21	0	5
Modest decrease	1	0	2	0	0	0
Substantial decrease	0	0	0	0	0	0

Perceived Change in Next Five Years
percent

Amount of Change	All	Largest	North America	Europe	Consortium	Other
Substantial increase	41	39	24	47	56	44
Modest increase	49	56	55	46	33	56
No change	7	5	14	5	11	0
Modest decrease	2	0	7	2	0	0
Substantial decrease	1	0	0	0	0	0

7. Threats Ranked

In which of the following areas, if any, do you envisage possible significant threats to individual banks or to the smooth functioning of the international financial system? (Please rate on a scale of 0 to 10: 0 = no threat; 10 = maximum threat).

a. Risks to Banks

All Respondents

percent

Possible Threat:	Serious	Moderate	Minor
Default by a major country borrower	33	42	25
Sovereign debt repudiation			
Isolated cases	12	33	55
Chain or concerted action	18	24	58
Rescheduling			
Large number	27	48	25
Large amounts	28	56	18
Negotiations breakdown	14	26	50
Unfavorable trend in terms	18	41	41
Mismatching losses in			
Short term maturities	20	40	40
Long term maturities	24	48	28
Currencies	22	34	44
Funding problems due to			
Severe tiering in interbank market	18	49	33
Unavailable interbank funds	20	27	43
Sudden, large deposit shifts	15	46	39
International operational problems			
Clearing mechanisms	5	23	72
Communications	6	15	79
Foreign exchange losses	23	33	34
Losses in precious metals, other commodities	11	33	56
Abrupt government actions or new controls	17	32	51

b. Risks to System

All Respondents
percent

Possible Threat:	Serious	Moderate	Minor
Default by a major country borrower	16	21	53
Sovereign debt repudiation			
Isolated cases	4	23	73
Chain or concerted action	17	21	62
Rescheduling			
Large number	17	40	43
Large amounts	18	40	42
Negotiations breakdown	14	21	65
Unfavorable trend in terms	10	30	60
Mismatching losses in			
Short term maturities	4	18	78
Long term maturities	5	22	73
Currencies	4	22	74
Funding problems due to			
Severe tiering in interbank market	8	28	64
Unavailable interbank funds	13	23	64
Sudden, large deposit shifts	9	29	62
International operational problems			
Clearing mechanisms	5	17	78
Communications	2	13	85
Foreign exchange losses	2	16	81
Losses in precious metals, other commodities	5	10	85
Abrupt government actions or new controls	10	30	60

Comparisons of National Supervision and Requirements

8. How Burdensome?

Do you believe that supervision and regulation of international lending by your government is more or less burdensome, overall, than supervision and regulation of your major competitors from other countries? (Please check the appropriate line):

Regions Compared
percent

	All	North America	Europe	Other
More burdensome	33	50	29	28
Roughly the same	47	36	56	39
Less burdensome	20	14	15	33

9. Advantages and Drawbacks

In what specific respects do you believe that your bank benefits or loses in international lending competition because of regulatory and supervisory differences among countries? (Please indicate whether differences between your home country's requirements and others' in any of the following constitute significant advantages or disadvantages in international lending for your bank):

Regions Compared

percent

	Advantage			Disadvantage			Mixed		
Requirement	North America	Europe	Other	North America	Europe	Other	North America	Europe	Other
Capital requirements	4	17	44	57	53	12	39	30	44
Reserve requirements	7	37	38	37	35	6	56	28	56
Liquidity requirements	19	24	27	11	37	40	70	39	33
Loan size requirements	21	39	31	55	23	50	24	38	19
Country exposure limits	15	57	56	30	9	13	55	34	31
Reporting requirements	11	23	38	35	21	31	54	56	31
Requirements for approval of specific transactions	68	50	25	12	22	50	20	33	25
Restrictions on permissible scope of activities	11	39	25	78	25	44	11	36	31
Foreign exchange restrictions	61	37	19	12	28	12	27	35	69
Credit controls	57	40	20	14	19	27	29	41	53

All Respondents
percent

Requirement	Advantage	Disadvantage	Mixed
Capital requirements	18	46	36
Reserve requirements	30	29	41
Liquidity requirements	23	28	49
Loan size requirements	33	34	33
Country exposure limits	46	14	40
Reporting requirements	24	26	50
Requirements for approval of specific transactions	50	24	26
Restrictions on permissible scope of archives	30	42	28
Foreign exchange restrictions	42	19	39
Credit controls	46	18	36

10. How Important?

Compared to other factors affecting banks' relative competitive advantages in international banking, how important are differences in regulatory requirements among governments?

Regions Compared
percent

	All	North America	Europe	Other
Very important	39	35	41	39
Somewhat important	53	62	50	44
Not important	8	3	9	17

11. Do Regulations Distort?

Do you believe that regulatory advantages enjoyed by certain banks create distortions that tend to impair the ability of banks in general to earn an appropriate return on international lending?

Regions Compared
percent

	All	North America	Europe	Other
Yes	51	59	60	28
No	49	41	40	72

12. Could Some Regulations Be Dropped?

Are there particular supervisory or regulatory requirements that are burdensome on your bank's international operations which, in your opinion, could be modified, reduced or eliminated without seriously affecting prudential objectives?

Regions Compared
percent

	All	North America	Europe	Other
Yes	46	59	42	39
No	54	41	58	61

13. Regulators' Attitudes

Do you believe that your home country supervisory authorities should be more sensitive to the international competitive implications of their actions and requirements on the banks they regulate?

Regions Compared
percent

	All	North America	Europe	Other*
Yes	46	66	36	47
No	54	34	64	53

* 94% response.

14. Recent Changes

Are there specific supervisory or regulatory changes, recently implemented (or proposed), which have significantly affected (or would significantly affect) your bank's competitive position in international lending?

Regions Compared
percent

	All	North America	Europe	Other
Yes	41	48	43	28
No	59	52	57	72

15. Regulation Assessed

In general, do you believe that supervisory and regulatory actions taken by your national authorities provide an effective, constructive influence on your bank's management of international banking risks?

Regions Compared
percent

	All	North America	Europe	Other
Yes	60	68	60	50
No	40	32	40	50

16. More Supervision or Less?

What changes would you like to see in the supervisory and regulatory environment affecting international banking activities?

Regions Compared
*percent**

Changes	All	North America	Europe	Other
More harmonization of requirements	73	83	74	50
Less supervision and regulation	40	38	27	56
Elimination of discriminatory requirements between domestic and international business	28	24	33	13
None of the above	9	10	11	6

* Totals add to more than 100% because some banks responded to several answers.

17. Pressure on Spreads

Which of the following factors do you feel have been most important in exerting pressure on spreads and other loan terms? (Please assign relative weights to the following factors on a scale of 0 to 10, where 0 = no importance and 10 = very great importance):

All Respondents
percent

Factors	Very Important	Moderately Important	Not Important
Supply and demand conditions	78	17	5
Aggressive pricing by lenders seeking to enter new markets	70	25	5
Aggressive pricing by banks enjoying regulatory advantages	40	35	25
Assumption of risks by governments	14	43	43
Perception of low risks in existing or new loans	21	27	52

18. Narrow Spreads

If spreads are widely perceived as "too narrow" what action or event might be required to improve them? Is there a role here for supervisory authorities? (Please comment)

For summary of answers, see text.

19. Profit Factors

In addition to average spreads on loans, which of the following factors are most important determinants of profitability in your international activity? (Please assign relative weights to the following factors on a scale of 0 to 10, where 0 = no importance and 10 = very great importance):

All Respondents
percent

Factors	Very Important	Important	Not Important
Fees paid by borrowers	57	31	12
Aspects of present or prospective business with borrower	47	39	14
Actual cost of funds below LIBOR	24	26	50
Future business opportunities with third parties	12	35	53

Largest Banks
percent

Factors	Very Important	Important	Not Important
Fees paid by borrowers	57	32	11
Aspects of present or prospective business with borrower	50	36	14
Actual cost of funds below LIBOR	24	35	41
Future business opportunities with third parties	11	29	60

20. When Should Authorities Support?

Assuming that supervisors or central banks could distinguish liquidity versus solvency problems threatening a particular bank, do you believe it would be appropriate for national authorities to give support in the event of a liquidity crisis but not a crisis of solvency?

Regions Compared
percent

	All	North America	Europe	Other
Yes	79	82	80	72
No	21	18	20	28

Do you think that it is feasible to make such a distinction in an emergency situation?

Regions Compared
percent

	All	North America	Europe	Other
Yes	41	21	48	41
No	59	79	52	59

21. Safequards

Please indicate your view about each of the following propositions:

- There is a need for clearer understanding about lender of last resort facilities for distressed banks
- Under present arrangements, the international banking system would be vulnerable to a "chain collapse" in the event of a crisis affecting a significant bank or group of banks.
- A jointly organized private international "safety net" arrangement would be an effective device for supporting individual banks in a liquidity crisis.
- There is a need for a supranational organization (e.g., IMF, BIS or a new institution) to assume the role of lender of last resort for the international banking system.

All Respondents

percent

Proposition	Agreement	Disagreement	No Opinion
Clearer understanding of lender of last resort needed	74	19	7
System vulnerable to chain collapse	62	36	2
Safety net arrangement effective device	47	47	6
New supranational organization needed	39	56	5

Cross Border Lending

22. Analyzing Risk

Has your institution increased its resources dedicated to country risk analysis in the past few years?

All Respondents
percent

Yes	No
92	8

If "Yes," what significant changes have been made? (Please check any of the following that apply):

All Respondents

Changes	Percent*
Country risk analysis unit established at headquarters	87
Specialist staff or consultants hired	74
More sophisticated analytical systems adopted	63
Increased data gathering activity	62
Increased visits to borrowing countries	41

* Total exceeds 100% because many respondents reported several changes.

23. Political Pressures

Do you believe that country lending by your nation's banks has been significantly affected by political or other pressures imposed by government authorities?

All Respondents and Largest Banks Compared
percent

	All Respondents	Largest Banks
Yes	24	26
No	76	74

24. The Lenders Trap

Do you believe that some banks in your country have been influenced to extend credit to certain countries beyond levels of normal prudence because of the weight of outstanding loans or commitments?

All Respondents and Largest Banks Compared
percent

	All Respondents	Largest Banks
Yes	26	22
No	74	78

Do you think this might be a matter of some concern in the future? (Please check the line that best represents your view):

All Respondents
percent

Serious concern	8
Concern in isolated cases	54
Not a serious concern	38

25. Supervisors' Attitudes

Please indicate your attitude toward activity by your home country supervisor with regard to the following aspects of country risk management (check the appropriate line in each part):

Regions Compared

percent

Country Risk Analysis

	All	North America	Europe	Other*
Constructive	52	62	52	56
Ineffective	30	28	33	19
Detrimental	0	0	0	0
Not Applicable	18	10	15	25

Monitoring Country Exposure

	All	North America	Europe	Other*
Constructive	51	66	48	56
Ineffective	30	21	37	19
Detrimental	2	3	0	0
Not Applicable	17	10	15	25

Country Exposure Levels

	All	North Amerca	Europe	Other*
Constructive	49	62	46	50
Ineffective	30	17	35	25
Detrimental	2	7	0	0
Not Applicable	19	14	19	25

* 89% response.

26. Should Banks Rely on Others?

Do you believe that it is inappropriate for banks to rely on country risk assessments by others (e.g., syndicate leaders, correspondent banks) in place of an independent analysis of their own?

All Respondents and Smaller Banks Compared

percent

	All Respondents	Smaller Banks
Yes	89	64
No	11	36

27. Monitoring Practices

Do you monitor country lending concentrations across all units of your organization on a worldwide, consolidated basis?

All Respondents*

percent

Yes	No	Not Applicable
87	2	11

* Not applicable to unconsolidated institutions.

28. Setting Credit Limits

Are country exposure limits for credits established and reviewed by your bank on a regular basis?

All Respondents

*percent**

Case by Case	Annually	Quarterly	Other
9	59	20	20

* Total exceeds 100% because some banks use several approaches.

29. Who Sets Limits?

At what level in your organization are country exposure limits established?

All Respondents
*percent**

Board	Senior Committee	International Division	Other
34	40	17	11

* Total exceeds 100% because some banks use several approaches.

30. Maturity Limits

a. Are specific country limits established for the distribution of loans by maturity?

Regions Compared
percent

	All	North America	Europe	Other
Yes	63	68	67	44
No	37	32	33	56

b. Specific country limits established by class of borrower?

All Respondents
percent

	Non-Banks		Banks		Governments		Individuals	
	Yes	No	Yes	No	Yes	No	Yes	No
All Respondents	27	73	43	57	26	74	16	84

31. Factors of Country Risk

In general, which of the following *factors* carry the greatest weight in your own bank's assessments of country risk? (Please assign relative weights to the following factors on a scale of 0 to 10, where 0 = no importance and 10 = very great importance)?

All Respondents, Largest and Smaller Banks Compared

percent

	Very Important			Moderately Important			Not Important		
Factors	All	Largest	Smaller	All	Largest	Smaller	All	Largest	Smaller
Analysis of political and social conditions	83	84	73	16	16	19	1	0	6
Quantitative analysis of economic data	80	77	74	17	23	13	3	0	13
Qualitative judgments of country specialists	64	73	43	27	13	43	9	14	14
Forecasts of key economic variables	51	32	60	39	32	33	10	16	7
Involvement of other banks	15	3	13	35	40	27	50	57	60

32. Sources of Information

Which of the following *sources of information or views* are most important in your bank's approach to country risk assessment? (Please assign relative weights to the following factors on a scale of 0 to 10, where 0 = no importance and 10 = very great importance):

All Respondents
percent

Source of Information	Very Important	Moderately Important	Not Important
Economic and social/political analysis prepared by headquarters staff	76	16	8
Reports by bank staff in or frequently visiting country	55	28	7
Analysis and views from the IMF or other multinational institutions	46	38	16
Overall assessments by other banks	27	43	30
Discussions with clients indigenous to the country	22	42	36
Proprietary reports obtained from consultants	20	33	47

33. Insurance and Cofinancing

Please indicate your views about the following propositions:

- Credit insurance schemes weaken or eliminate the credit evaluation efforts of commercial lenders and thus increase system risk.
- Cofinancing arrangements with official institutions weaken credit evaluation efforts of commercial lenders and thus increase system risk.
- An IMF country credit rating system would weaken or eliminate the credit evaluation efforts of commercial lenders and thus increase system risk.

Regions Compared

*percent**

	All		North America		Europe		Other	
	Agree	Disagree	Agree	Disagree	Agree	Disagree	Agree	Disagree
Credit Insurance Schemes	33	57	21	58	44	50	6	89
Cofinancing Arrangements	16	73	4	86	25	66	11	72
IMF Country Credit Rating	24	66	17	66	34	58	17	83

* Percentages do not total 100% because figures exclude answers of "no opinion."

34. Existing Arrangements Adequate?

If rescheduling of country debt becomes more frequent in the next few years, possibly involving larger amounts than in the past, do you think that existing ad hoc arrangements among banks, governments and multilateral organizations would be adequate to handle the task without disrupting the international financial system?

Sizes Compared
percent

	All	Largest Banks	Midsize Banks	Smaller Banks
Yes	29	20	42	19
No	17	16	17	18
Uncertain	54	64	41	56

35. Any Changes?

As a result of past experience with reschedulings, have any important changes been made in your bank's policies and practices?

All Respondents
percent

Yes	No
36	64

36. Indirect Costs

To what extent do you consider the following indirect costs of debt rescheduling to be significant present or prospective concerns for your bank?

Sizes Compared
*percent**

Costs:	Present Concern				Future Concern				No Concern			
	All	Largest	Midsize	Smaller	All	Largest	Midsize	Smaller	All	Largest	Midsize	Smaller
Management time dedicated to work outs	35	42	39	38	52	52	46	50	18	8	21	25
Opportunity cost of funds locked in portfolio	20	29	21	19	60	60	59	56	24	13	27	31
Reduced present value of loan income	22	22	25	19	52	60	54	50	29	19	29	37
Reduced quality of loan portfolio	27	42	21	19	57	50	64	63	21	10	21	25

* Totals exceed 100% because some banks responded to several answers.

37. Maturity Mismatching

Has the experience of high volatility in interest and exchange rates caused your organization to alter its maturity (gapping) and currency mismatching practices in the Euromarket?

All Respondents
percent

	All	Largest	Midsize	Smaller*
Yes	42	47	43	33
No	58	53	57	67

* 92% response.

38. Funding Operations

Which of the following best describes your bank's approach to managing funding operations of units operating in different markets? (Please check one):

All Respondents
*percent**

Approaches	
All major funding operations controlled closely by headquarters	49
All major funding operations monitored centrally for individual units	41
All major funding operations decentralized to individual units	13
Other methods	3

* Total exceeds 100% because several banks use more than one approach.

39. Monitoring Performance

How do you rate your supervisory authority's performance in monitoring individual bank maturity mismatching?

Regions Compared
percent

Performance	All	North America	Europe	Other
Excellent	7	4	9	11
Good	40	50	38	33
Fair	32	28	35	22
Poor	6	11	5	6
Not applicable	15	7	13	28

40. Smaller Banks

a. Do you believe that a relatively conservative funding approach is appropriate for smaller banks or those not so well known or established in the market as the leading institutions?

Sizes Compared
percent

	Largest	Midsize	Smaller
Yes	100	90	100
No	0	10	0

b. Do you believe that practices of such institutions are in fact different from those of larger banks?

Sizes Compared
percent

	Largest	Midsize	Smaller
Yes	64	64	57
No	36	36	43

41. Deposit Concentration

Does your bank monitor concentrations of deposits by geographic source?

Sizes Compared
percent

	All	Largest	Large	Midsize	Smaller
Yes	62	79	66	38	50
No	38	21	34	62	50

42. Deposits Refused?

Has your bank ever turned away large deposits specifically to avoid geographic concentrations of deposits?

Sizes Compared
percent

	All	Largest Banks	Large Banks	Midsize Banks	Smaller Banks
Yes	25	41	21	15	12
No	75	59	79	85	88

43. Do Supervisors Monitor Deposits?

Does your home country supervisor monitor geographic concentrations of deposits in your bank?

Regions Compared
percent

	All	North America	Europe	Other*
Yes	37	52	35	19
No	63	48	65	81

* 89% response.

Interbank Business

44. Deposits and Redeposits

What proportion of international interbank deposits taken by your bank is normally redeposited with other banks? (Please check the line below indicating the normal range for your bank):

Sizes Compared
percent

Proportion Redeposited	All	Largest	Large	Midsize	Smaller*
Less than 20%	18	8	11	37	21
20-39%	32	33	43	22	29
40-59%	24	33	21	19	14
More than 60%	26	26	25	22	36

* 88% response.

45. Is Trading "Excessive"?

For the system as a whole, or for certain banks, do you believe that the level of interbank funding or trading is in any sense "excessive"? Please comment.

All Respondents
*percent**

yes, for system	no for system	yes for some banks	no view
9	48	31	12

* 68% response.

46. More Risky?

Do you believe that interbank activity is becoming more risky because of change in the composition of participants, i.e., an increasing proportion of interbank borrowing by banks that are relatively higher risks?

Sizes Compared
percent

	All	Largest	Large	Midsize	Smaller*
Yes	56	54	62	58	47
No	44	46	38	42	53

* 94% response.

47. Interbank Limits

Does your bank regularly set overall and daily limits on interbank placements by bank? by country of deposit? by currency of deposit?

Sizes Compared
percent

	All		Largest		Large		Midsize		Small	
Limit	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
By bank	92	8	100	0	93	7	85	15	81	19
By country	82	13	94	6	79	21	83	17	91	9
By currency	43	57	29	71	37	63	28	22	36	64

48. Deposit Rule

With regard to decisions on interbank deposit placements, does your bank follow certain rules of thumb (e.g., place funds only with the largest X banks in the world or in a particular country, or operate with a short, specific list of most highly regarded banks)?

For summary of answers, see text.

49. Grading Banks

In judging credit risk and allocating interbank placements, which of the following are the most important sources of information for decision-makers in your bank? (Please assign relative weights to the following factors on a scale of 0 to 10, where 0 = no importance and 10 = very great importance):

Sizes Compared
percent

	Largest			Midsize			Smaller		
Sources of Information	Very Important	Moderately Important	Not Important	Very Important	Moderately Important	Not Important	Very Important	Moderately Important	Not Important
Financial analysis prepared by own staff	89	11	0	89	4	7	81	13	6
Visits to bank by own staff	66	29	5	63	30	7	60	33	7
Advice from correspondent banks	28	58	14	50	46	4	60	40	0
Views of own money traders	23	53	24	46	39	15	15	62	23
Reports prepared by outside services	11	26	63	8	48	44	0	38	62
Views of clients in banks home country	6	23	71	12	38	50	7	31	62

50. Banks and Their Countries

Does consideration of country risk play a significant role in your bank's decision on interbank placements and credits?

Do you specifically evaluate the willingness and capacity of foreign banks' home government and central bank to support them in case of adversity?

Sizes Compared
percent

	All		Largest		Large		Midsize		Smaller	
Considerations	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
Country risk	98	2	100	0	97	3	96	4	100	0
Government support	68	32	76	24	59	41	69	31	62	38

51. What Supervision?

Does your home country supervisory authority monitor your bank's international interbank lending and deposit placement activity?

Regions Compared
percent

	All	North America	Europe	Other*
Yes	64	83	53	65
No	36	17	47	35

* 94% response.

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Address inquires to:

The Group of Thirty
Two World Trade Center
Suite 9630
New York, New York 10048
Tel: 212-775-9160

Group of Thirty

The Group of Thirty was established in December 1978, to explore basic problems in the functioning of the international economic system. It meets twice a year, for two to three days at a time. Between these meetings, study groups and researchers gather material to serve as a basis for the Group's discussions.

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GROUP OF THIRTY

Risks in International Bank Lending

First Report of the International Banking Study Group
of the Group of Thirty

Geoffrey L. Bell
John G. Heimann

Peter Cooke
Otmar Emminger
Rainer Gut
Leland S. Prussia

Edmond J. Safra
Henry Wallich
Dennis Weatherstone
Malcolm Wilcox

Executive Secretary: C.F. Muckenfuss
Study Coordinators: Judith A. Walter
Steven J. Weiss

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Risks in International Bank Lending

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Risks in International Bank Lending

Introduction

The purpose of this study is to discuss the greater risks that may have arisen in the course of the rapid growth in international bank lending during the 1970s and to make suggestions aimed at strengthening the capacity of the system to manage those risks.

The report is the work of a study group on international banking that was established by the Group of Thirty in mid-1980. The establishment of the study group reflected a perception by the Group of Thirty that the growing integration of national banking systems combined with the rapid expansion of bank lending across national borders raised a wide range of issues both for banks and banking supervisors — issues that had not been fully explored.

At their broadest, the Group of Thirty's concerns may be expressed as follows: has growing integration brought with it a loss of control? This question immediately raises many others: are the risks involved in international bank lending — and the funding of that lending — different in kind, or only in degree, from the risks inherent in all banking activity? Has it created new problems that are not readily manageable by banks or individual banking authorities working alone? Should banks be left wholly free to decide for themselves, for example, the degree to which they should "borrow short and lend long"? Or the extent to which they should finance countries' balance of payments deficits? How far-reaching would be the implications of a default by a major borrowing country, or a collapse of a large bank? Are existing arrangements for 'risk containment' adequate?

Such were the range of questions which the study group was asked to address. In raising the issues in this way, the Group of Thirty did not mean to imply that it believed that international banking had suddenly become more risky. The Group recognized that the banking system had performed its "recycling" role in a remarkably smooth fashion, and without major mishap. Equally, the Group recognized that banking supervisors were themselves examining issues raised by the growth of international bank lending, and were monitoring developments in this field. At the same time, the Group believed that a study conducted by practicing bankers in cooperation with banking supervisors and others with wide experience in this field could make a distinctive contribution to public discussion and understanding of these issues.

As background for its deliberations, the study group commissioned a review of existing literature on international banking supervision and risk and some original analysis of selected topics, much of which took the form of papers specifically prepared for study group meetings. The bibliographic search and many of the analytic studies were undertaken by research staff of the U.S. Office of the Comptroller of the Currency (OCC). (Two such studies are appended to this report.) Direction and oversight of the background efforts were carried out by the Study Group's executive secretary, C.F. Muckenfuss III (at that time Senior Deputy Comptroller for Policy at the OCC) and study coordinators Steven J. Weiss and Judith A. Walter (Director and Deputy Director, respectively, of the OCC's Strategic Analysis Division). The Group of Thirty owes a debt of gratitude to them and to many others who have assisted in the work of the study group, notably toMr. Inigo Woolf and Charles Larkum of Midland Bank and Mr. John Henderson of Schroders.

The present report, which gives the results of the study group's deliberations, should be read in conjunction with the results of a comprehensive survey of banks conducted by the Office of the Group of Thirty on behalf of the study group, published under the title "How Bankers See the World Financial Market".

The following report focusses on three areas:

(1) country risk and the rescheduling of sovereign debt
(2) maturity transformation and the interbank market
(3) the handling of distressed banks

The study group believes that these areas merit special attention because they cover the range of issues that are raised (or could be raised) at an international level by the expansion of international lending and growing financial integration. Other areas, such as the risks in foreign exchange trading, while more complicated and perhaps less tractable as a result of the internationalization of banking, are nevertheless more endogenous to individual bank policy and thus more readily controllable by national supervisors.

In what follows, the discussion of each topic has been cast in a uniform format to the extent possible. Background information of a factual nature is set forth briefly in the opening paragraphs of the individual subsections. Next, concerns that have been expressed relative to a given topic are summarized. Evaluation of the concerns draws on secondary sources, the collective experience of the study group, and the above mentioned survey of 111 commercial bankers entitled "How Bankers See the World Financial Market".

Robert Pringle
Executive Director
Group of Thirty

May, 1982

Disclaimer

This report was drafted by the International Banking Study Group of the Group of Thirty. Some of those who participated in meetings of the study group hold official positions and attended as observers. They cannot for obvious reasons be held responsible for the views expressed in the report. Indeed, all the members of the study group attended its meetings in a personal capacity and policy recommendations cannot in any respect be taken to represent the views of institutions with which members are associated.

Risks in International Bank Lending

1. COUNTRY RISK

The large increase in international bank lending since 1973-74 has been accompanied by significant changes in the nature as well as the relative magnitudes of such activity from the standpoints of both borrowers and lenders. One of the distinguishing characteristics of many international loans during this period has been their purpose — the funding of current account deficits. Countries have resorted to overseas borrowing on an unprecedented scale to cushion the impact of adverse changes in their external circumstances — notably spiraling energy costs — and to finance industrialization and economic development programs. The result, for a number of borrowers, particularly some LDCs, has been a rapid increase in debt burdens, aggravated by high interest rates. For example, the ratio of debt service to export earnings for ten major LDC exporters of manufactured goods is estimated to have jumped from 13 per cent to 21 per cent between 1974 and 1981[1]. The outstanding debt owed to banks by four groups of major borrowers — smaller European countries, OPEC, Eastern Europe and non-oil LDCs totalled nearly $400 billion at the end of 1980.[2]

Moreover, whereas balance-of-payments financing needs were formerly viewed as short-term, cyclical, liquidity problems, current payments imbalances are often structural in nature. As a result, many borrowing countries now face periods of basic structural readjustments. Thus, greater demands are being placed on domestic management capabilities of borrowing countries to devise and implement the necessary economic adjustment programs.

While borrowers' debt burdens have grown, so have the relative magnitudes of banks' international loans in loan portfolios. Recent U.S. data highlight the growing importance of LDC borrowers: the aggregate exposure of the nine largest U.S. banks to LDCs has increased from 1½ times total capital in 1977 to more than double capital in 1980, and by the end of 1980 there were 80 instances of U.S. banks with exposure to single LDCs greater than 30 percent of capital funds. More generally, foreign assets and liabilities now account for a large proportion of total assets and liabilities of the banking systems of many OECD countires: for the OECD as a whole, the ratio nearly doubled during the 1970s, from 12 per cent to about 22 per cent.

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[1] IMF: *World Economic Outlook*, June 1981, p. 135.

[2] BIS Annual Report, 1981, p. 105.

Risks and Concerns

The extension of credit across national borders in non-local currencies complicates the traditional assessment of a borrower's ability to repay because "country risk" is a factor. Under the rubric of "country risk," most analysts distinguish "transfer risk" from "political risk".[3] "Transfer risk" is the danger that a country may impose restrictions on remittances of capital, dividends or interest payments to foreign investors as part of its economic policy. In addition, repayment may be endangered by political developments, like civil or local wars.

Recently, concern about country risk has increased. There is a general belief that, at the same time as more and more banks are involved in international lending and the relative magnitude of the international portions of loan portfolios has been growing, the actual risk inherent in such activity has grown. At the same time, there is skepticism about the efficacy of approaches that banks have taken to country risk assessment.

The concerns suggest two lines of inquiry:

1) Have the risks of international lending increased? If so, how?
2) How are banks managing those risks? What is the supervisor's role?

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[3] A few definitions of terms may be useful to the reader:

Country risk is taken to refer to the possibility that sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable, to fulfill their foreign obligations for reasons beyond the usual risks which arise in relation to all lending.

Country risk assessment, following on from the above, refers to the methods used (by lending banks in particular) to evaluate the risk of an interruption in the servicing or repayment of obligations by borrowers of a particular country.

Country exposure is taken to refer to an individual bank's or banking group's exposure in its total claims on borrowers in individual foreign countries. Measures of exposure to a particular country may take account of guarantees or other factors that could shift risk to a different country from that of the borrower.

Country indebtedness is taken to refer, in an international context, to the sum total of external borrowing by a particular country from all sources.

Sovereign risk arises from the special risk associated with a sovereign loan, which is a loan to, or guaranteed by, a government (and some government-guaranteed bodies). The special significance of such lending lies in the risk that it might prove impossible to secure redress through legal action i.e. the borrower might claim immunity from process or might not abide by a judgment.

The second area, that of risk management practices, in turn raises a series of subsidiary questions:

- What techniques of risk management and/or reduction are employed?
- Is country risk assessment effective? What are its flaws?
- Are some banks better positioned than others to assess country risk?

Gauging the Overall Risks

The most frequently used indicator of the risk of bank lending activity is the loan loss record which can be used to assess risks in relation to particular categories of lending. Across-the-board data for major international banks engaged in international lending are not available, but the loan loss statistics for the largest U.S. banks may be representative. By this measure, the record appears to be reassuring since loan losses have been far lower for international than for domestic activities. Moreover, the loss record has been improving. For the ten largest U.S. banks, international net loan losses as a percent of average international loans dropped from a record 0.39 per cent in 1976 to 0.10 per cent in 1980. International net loan losses relative to total losses have also dropped, from a peak of 29.3 per cent in 1977 to 15.3 per cent in 1980. However, such statistics do not reflect the less direct costs of reschedulings to banks. Although most banks say those indirect costs in management time, liquidity, income and portfolio quality have not been high to date, many believe those costs may grow.

The views expressed in the accompanying banking survey[4] on future riskiness of international bank lending were mixed: 40 per cent of respondents expected a 'substantial increase' in the riskiness of international lending over the next five years to the end of 1986, but a majority expected 'no significant change' or a 'modest increase'. A large number of reschedulings involving large sums or a default by a major country borrower were seen as the most serious threats to the system.

How Banks Assess Country Risk and Manage Exposures

Existing systems for assessing country risk vary in approach and complexity from bank to bank. The study group's bank survey confirmed that nearly all banks have increased the resources dedicated to country risk analysis (it also confirmed that smaller banks rely more than larger ones on country risk assessments by others, such as syndicate leaders and correspondent banks).[5] However, there are acknowledged problems with both the economic and the political sides of country risk assessment systems.

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[4] "How Bankers See the World Financial Market", Group of Thirty, May 1982.

[5] Appendix I summarizes nine systems which have been used or are in use at some major U.S., Canadian, and European banks.

The more serious problems on the economic side stem from the deficiencies of the data. True, the quality of data has improved somewhat in recent years, and additional efforts at improvement are currently under way. (For example the IMF and BIS have recently been discussing efforts to expand and improve banking information.) Nevertheless, there remain some significant deficiencies in both the quality and availability of the data.[6]

Lags in data reporting can be quite serious, sometimes rendering the available statistics virtually useless. There is much evidence that many banks simply did not know the magnitude of the debts of either Turkey or Poland, before the crises in those countries erupted.

Even assuming reliable and current economic data, however, there are still differences of opinion regarding how well banks use and interpret the data. There are past instances, for example, of banks' enthusiasm for lending being based on a country's natural resource endowments without a concomitant realistic appraisal of the country's ability to *manage* its natural resources. Currently, most country risk analysis systems utilize a number of economic indicators to develop measures that serve as indicators of country risk. While the ratio of debt service to exports is widely acknowledged as an important measure, opinions differ as to the significance of a number of other measures often used to predict the ability to service debt.

Recently, banks have placed increased emphasis on assessing political and social factors in borrowing countries. A number of banks have hired political experts and incorporated political considerations in their analysis in new ways, including attempts to develop lists of socio-political "early warning indicators." However, such judgments are no doubt even more problematical than economic analysis. Despite new attempts to take political factors into account, such analysis has often failed to detect important trends, such as political developments which, for example, in the case of Poland, may have contributed to the need to reschedule.

In the end, of course, even very sophisticated country risk assessments may be overridden by other considerations. Final action may run the range from voluntary decisions, based for example on perceptions of marketing opportunities, to those that are less than fully voluntary. Examples in the latter category would include situations where the bank is afraid of jeopardizing a large existing exposure if it withholds new loans or instances of strong external pressure from the bank's home government arising from foreign policy motivations: one quarter of banks responding to our survey believed that lending had been significantly affected by such pressures. Also, since a bank's competitive status depends importantly on the regard of others in the system, some banks may feel pressured by the desirability of cooperating with other lenders. Finally, some banks may act, at least in part, out of a sense of responsibility to help maintain the longer-run stability of international lending markets.

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[6] Country debt service data, for instance, do not capture all annual amortization requirements; military debt, which is often large, is usually excluded from official statistics; and statistics on short-term debt (up to one year) are frequently deficient.

Competitive pressures may lead banks to override country risk assessments and engage in imprudent lending. Particularly in the early stages of country lending, competitive behavior tends to dominate. This can mean that new money will continue to pour into a country once it is "in vogue," even though signs of economic difficulty may already be evident. For instance, in the cases of Peru, Turkey and Poland, even when banks were beginning to feel more cautious about further lending, those countries were able to sustain the inflow of funds. In such ways, a country can accumulate excessive debt.

Debates about the efficacy and actual use of country risk assessment systems notwithstanding, banks can and do protect themselves from undue risk concentrations in a number of ways. For example, there are means by which banks reduce or spread the risks of involvement with a particular lender. These include syndication of large loans, co-financing with multilateral institutions, insuring loans with either private or public agencies, or securing home government guarantees through national export banks or agencies.

Most importantly, banks typically follow policies and practices promoting loan portfolio diversification as the main method of managing international risk exposure. Nearly all banks set lending limits to individual countries, sometimes as a proportion of capital and reserves or of external or total assets. To arrive at limits, subjective judgments (whether derived from elaborate country risk analyses or not) are translated into objective ceilings. Most banks can follow strategies that allow them to allocate, measure, and monitor quite closely their country risk exposures.

Supervisory Practices

Supervisory practices also play a part in the management of country risk. In general, the principal role of the supervisory authorities is to help the individual bank carry out the task of country risk assessment on its own responsibility and to satisfy themselves about the ways in which the bank evaluates country risk and monitors its own exposure to each country. It is not entirely clear how and to what degree various national regulatory authorities currently fulfill this role. However, bank supervisory evaluation of bank's country risk systems does appear to be becoming more widespread. Also, supervisors follow more closely than formerly trends and concentrations of risk in their banking systems, and/or at individual banks, by collecting statistical reports on country exposure. In the U.S., because of the nature and history of bank supervision, supervisory authorities make an independent judgment regarding the risk in lending to particular countries.

The practice is not much in evidence elsewhere; but many countries apply requirements designed to prevent undue risk concentrations. (A description of supervisory systems in a number of G-10 countries is at present being prepared by Richard Dale of the Brookings Institution, to be published later this year as part of the overall work of The Group of Thirty. Meanwhile, a brief overview of relevant national regulatory arrangements is supplied in Appendix D).

Conclusions

There have been no major disasters for the international banking system arising from the growth in international lending activities. However, our survey confirms that most bankers believe that risks have increased and will increase more rapidly in the future. Evaluating the degree to which this may be true is of course no simple matter. For instance, there are factors which appear to mitigate the relative burden of debt for some borrowers. These include growing GDPs, higher levels of reserves, and above all improvements in economic policy-making in most debtor countries enhancing their own ability to adjust to changes in external circumstances. Yet the rapid growth and relatively high level of international indebtedness has certainly increased borrowers' vulnerability to exogenous events which could impair their ability to service debt. At the same time, the growth in the ratio of international to domestic assets in bank portfolios suggests that the system's vulnerability to 'shocks' may also have increased.

The concerns generated by aggregate figures on debtor condition and country exposure are often exaggerated. A variety of official support functions are already in place. To the extent that ultimate country lending risks are borne by government or multilateral institutions which lend directly, co-finance with banks, subsidize, insure or guarantee bank loans, the actual risk of commercial banks is at least partly underwritten.

More significantly, borrowers represent a range of risks, and banks manage their exposures with the intention of avoiding undue concentrations of risk. Especially in the last several years, banks and their supervisors have devoted considerable effort to improving management of international loan portfolios. The question remains as to whether these efforts are fully adequate at a time when the system has probably become more vulnerable to shocks — and perhaps more likely to experience them. Weighing these partly conflicting considerations, the study group believes the following observations are relevant:

1) Banks' decision-making sometimes appears to take place against a background of insufficient factual information. This is partly because

there remain serious inadequacies in the data upon which country risk assessments are based. International debt data for short-term borrowing are particularly deficient. Further efforts should be made to improve the quality, timeliness and availability of the basic economic data available to lenders.

2) To this end, means for centralizing data collection could be explored. Many members of the study group believe that some degree of centralization of data analysis would be also be appropriate. Judgments and decisions, however, should be left to individual banks.

3) Risk assessments may be influenced by other considerations. There is evidence that competition for business within the international banking market has sometimes resulted in excessive debt accumulation by borrowers, leading subsequently to debt servicing problems.

4) The study group believes that bank supervisory authorities should be concerned with reviewing country risk management systems. However, it is not yet possible to reach firm conclusions about the effectiveness of such reviews. It is also the opinion of the study group that, as a general principle, supervisors should leave the task of actually making country risk assessments to the banks (while recognizing the special circumstances of U.S. supervisors, who are required by law and practice to make loan quality judgments).

2. RESCHEDULING

The number and magnitudes of country debt rescheduling have increased considerably in the last six years. Since 1956, there have been 53 official debt reschedulings involving 20 countries. Twenty-two of these involving 13 countries have occurred since 1975. In the recent past, banks have been a party in renegotiations with seven countries — Turkey, Zaire, Peru, Nicaragua, Sudan, Jamaica, Poland. Discussions are currently under way with Rumania, Costa Rica, Senegal and Liberia. The amounts involved in these reschedulings have varied greatly: $518 million for Peru in 1978, $421 million for Sudan and $1.3 billion for Zaire in 1979, $580 million for Nicaragua and $3 billion for Turkey in 1980. Rescheduling of Poland's debt repayments of capital due in 1981 alone involved $2.2. billion. (Poland's aggregate debt owed to banks outside Comecon, at about $17 billion, is a different order of magnitude from that of any other country previously involved in rescheduling).[7] Most of the banks' exposure to loans subject to rescheduling so far, however, have been relatively small in relation to their capital or earnings.

Concerns

The possibility of a substantially larger rescheduling, or a series of them, involving large numbers of banks, has created concern whether processes presently used will be adequate for the debt rescheduling of the 1980s. First, the rescheduling process is not codified and involves large numbers of participants — official creditors, banks and other private lenders, multilateral institutions, the borrower, and sometimes, investment bankers who are advisors to the borrowers. Second, increasingly serious consequences may arise from the conflict between creditors' responses and debtors' needs.

Again, the result of the G-30 survey are pertinent to these issues. Asked whether existing *ad hoc* arrangements would be adequate to deal with more frequent reschedulings involving larger amounts than in the past, 17 per cent said no, 54 per cent were uncertain, and 29 per cent said yes (i.e., were content with existing arrangements).

The concerns point to two sets of questions:

1) What are the arrangements usually adopted for rescheduling, their strengths, weaknesses, and risks?
2) What have the terms of rescheduling been? What have the consequences been for lenders and borrowers?

The Rescheduling Process

The rescheduling of official debt is handled by the Paris Club, an *ad hoc* group of western official creditors which, since 1956, has met informally when needed under the chairmanship of the French Treasury. Although there are no formal rules, the Paris Club has over the years adopted a set of unwritten procedures. The common practice is that the request for a meeting is initiated by the debtor country; generally the creditors have agreed to convene only after payments arrears have already occurred; and an agreement is concluded after the borrower has agreed to an IMF stabilization program. Since the only debt eligible for consideration is government obligations, the practice has been to include as participants at the meetings only the borrower and the principal OECD government creditors. Observers may include other government creditors, the IMF, World Bank, the OECD and UNCTAD. The unwritten rules extend also to the amount eligible for rescheduling (about 80 per cent of consolidated official debt over a 2-3 year period) and the repayment terms.

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[7] Under an agreement signed in April, 1982, repayments of the $2.2 billion in capital that fell due in 1981 is to start in December 1985 and end in December 1988, with the interest rate for the sum rescheduled set at 1.75 per cent over LIBOR.

Because of the changing composition of developing country debt, banks have increasingly become involved in the rescheduling process. Hence troubled country borrowers may have to seek relief from the Paris Club or private banks or both.

There is no standard mechanism for rescheduling debt to private creditors; each case has required than an entirely new process be stated. The numbers of bank creditors involved in recent reschedulings and their nationalities have been large and growing — 115 banks from 12 countries in the case of Nicaragua, over 200 creditors for Turkey, and 500 for Poland. A small number of lead banks, usually a dozen of fewer, have formed a steering committee that actually participates in discussions. The members of the group may be selected by the borrower or the major creditors or jointly.

Bank reschedulings have been costly and time-consuming. Arrangements have taken from 6 months to 4 years to complete. Participants in the numerous loan syndications have had to be contacted; sometimes primary collection of basic data on outstanding loans has been necessary. A number of times the negotiations have had to be coordinated with parallel Paris Club rescheduling discussions. Procedural quarrels have sometimes added to delay.

Even though banks begin to "close ranks" once a rescheduling appears imminent, there is still a tendency for individual banks or groups of banks to pull in different directions. Thus it has been difficult at times to get agreement on coherent strategy. A 1976 bankers' attempt to obviate rescheduling by extending a balance-of-payments loan to Peru, for example, was undercut when some other banks simultaneously reduced their short-term credit lines to Peru. Divisions among banks during a time of crisis tend to be along national lines. The divergence may have any number of roots, including relative levels of exposure to a particular country, political pressures from home governments, or different accounting practices and/or capital requirements.

In most reschedulings the IMF plays a critical part in devising and imposing needed economic adjustment programs. As mentioned earlier, since 1966 the Paris Club has refused to proceed with reschedulings until the borrower has agreed to an IMF adjustment program. Banks, too, have sometimes made their rescheduling contingent on the borrower's acceptance of IMF conditions. In the case of Peru, banks discovered that they alone did not have the sanctions to impose conditions for economic adjustment.

Poland's application to rejoin the IMF aroused expectations that such a move would facilitate the rescheduling of Poland's 1982 debt repayment.

The IMF can play a useful role as a catalyst exerting pressure on both sides to move towards a settlement. Indeed, in the Nicaragua rescheduling, where the IMF was not itself involved, other multilateral institutions such as the InterAmerican Development Bank , World Bank, and Central American Bank for Economic Integration played a somewhat analogous role.

Rescheduling Terms

With few exceptions, rescheduling whether by Paris Club or private creditors has consisted of a lengthening of maturities of principal repayments at market rates of interest. Banks have been particularly insistent on maintaining commercial terms and (except in the case of Nicaragua) have thus far upheld the principle that interest payments may not be rescheduled. Although borrowers have negotiated for lower spreads and fees, they have tended to accept lenders' determinations of grace periods and final maturities. For Paris Club debt the average maturity has lengthened only from 8 to 10 years since 1975. Bankers have rescheduled on similar terms with average terms of 7 to 10 years with up to 3 years grace at rates of LIBOR plus 1¾ to 2 per cent.

Creditors have so far emerged relatively undamanged from rescheduling. Paris Club creditors have undertaken no concessional debt restructurings since 1971. In a present value comparison of official loans before and after the debt rescheduling over the period 1956-1980, Chandra Hardy estimated the loss to creditors at only about $2 billion or 0.5 percent of the total debt outstanding and noted that "since 1975, there has been no loss to the (Paris Club) creditors."[8] Although it is not possible to duplicate these calculations for bank debt, estimates indicate that private creditors have probably not suffered a financial loss on a present value basis either. From the borrowers' perspective, however, the terms have been quite onerous, failing to reflect their likely cash flows and essential adjustment plans. Short maturities and creditors' insistence on rescheduling only one year's debt at a time have increased the likelihood of subsequent liquidity problems and the necessity for a subsequent rescheduling.

Conclusions

Most members of the study group believe that the present *ad hoc* mechanism may be insufficient for the needs of the 1980s. They emphasize that future reschedulings are likely to be larger, more numerous and more complex, increasing the risks that the present system will prove inadequate, partly by creating intolerable delays. Most, then, see a need for banks collectively to be better organized to handle their role in rescheduling more effectively.

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[8] Chandra Hardy: "Rescheduling Developing-Country Debts, 1956-80; Lessons and Recommendations" Overseas Development Council Working Paper, No. 1.

There also appears to be a need for re-thinking the principles on which rescheduling terms are struck. It is nearly always true, of course, that opinions about optimum terms for debt repayment will differ among negotiators. In some cases, the outcome appears thus far to have been reasonably satisfactory — the experience of Turkey and Jamaica may be cited. However, in some cases of sovereign debt reschedulings it has been argued that the terms have been based on an excessively narrow or short term view by the banks on their own best interest. On this argument, by focusing solely on the criterion of reaching an agreement on market terms, creditors may either have failed to recognize or turned a blind eye to economic and political realities confronting the borrowers. The result sometimes has been to set in place conditions likely to result in more problems later — an eventuality that is in the best interest of neither the banks nor the borrower.

There are precedents for less rigid approaches to debt restructuring in bank relationships with corporate borrowers. Given increasing recognition that the balance-of-payments problems of many borrowing countries stem from long-term structural development needs, the challenge for future reschedulings will be to reach terms that strike a better balance between the medium-term interest of banks and the timescale over which borrowers realistically are able to resume full debt service. While putting this forward as an ideal the study group is nevertheless aware of the practical difficulties of achieving an optimum arrangement. Banks in international syndicates are subject to different national taxes and national regulatory laws and supervision. "Equal" treatment for a borrower in an international rescheduling could mean unequal treatment for lenders. The essential point is that all interested parties should get together at an early stage in a country's debt-servicing difficulties. The study group feels that the IMF should usually play the leading role in gaining acceptance by all parties to the key elements in a stabilization program. However, in the group's judgment, there is also a strong case for considering the establishment of a representative body for the banking industry to help improve the flow of information available to lenders, discuss issues related to debt servicing difficulties and develop expertise in this area that would be of assistance to both borrowers and lenders (see chapter 7).

3. INTERNATIONAL INTERBANK MARKET

The international interbank market links banks to one another much as domestic money markets link banks within national markets. The market owes its existence to the need of banks to be able to bid for funds of a particular maturity to fund a loan of a similar maturity and their need to lay off unwanted deposits with other banks. Funds are thus shifted within the international banking system — and between the international market and domestic markets — as banks take deposits from and/or place deposits with one another. The market serves an important intermediary function between savers and borrowers on a global basis. By reallocating funds in the same currency among banks, it also permits participants to generate and/or manage liquidity.

Initially limited to transactions among major multinational banks, the market has grown from a few hundred banks in the mid-1970s to well about 1,000 banks from more than 50 countries by 1981.

According to BIS estimates, the size of the market grew from about $182 billion in 1975 to $522 billion in June, 1981. The world's largest banks play a predominant role in the international interbank market. The banks to which they lend typically relend a certain proportion as well. Most banks participate actively on both sides of the market. Reliance on interbank funding tends to be higher for smaller banks and newcomers in the international market, banks without a U.S. dollar base, and consortium banks. The market constitutes an indispensable source of funds for many banks' international activity; a recent study suggests that interbank deposits account for between two thirds and three-quarters of total external and Eurocurrency deposits.[9]

Two features deserve special mention — the practice of redepositing and the classification of banks according to perceived riskiness ("tiering"). It is not uncommon for funds from nonbank depositors to pass through a chain of interbank transactions before finding an ultimate borrower outside the banking system. Active trading on both sides of the market may accomplish one or more of the following purposes: (1) keeping the bank's name in the market; (2) enhancing the size of bank by increasing total footings; (3) establishing reciprocal relationships that will assure access to liquidity, or access at a reasonable price, in event of a squeeze (banks that only take funds are said to fare especially poorly when markets are tight); (4) gathering current market intelligence about both changing conditions of supply and demand in the market and the market's sense of the needs and conditions of individual participants. The bank survey shows that most banks re-deposit more than 40 per cent (nearly 60 per cent in the case of the largest banks) of interbank deposits.

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[9] J.G. Ellis, "Eurobanks and the Interbank Market" *Bank of England Quarterly Bulletin*, September 1981.

The perceived risks of placing deposits with particular banks have been reflected in pricing tiers and/or credit limits. The number of tiers and differences in rate between them tend to increase in times of market uncertainty. The Herstatt collapse of 1974, though originating in overtrading in the foreign exchange market, appears to have provoked an extreme instance of pricing tiers; some banks paid as much as 2% above LIBOR. However, the pattern of interbank rates returned to normal within a few months.

In current practice, differentiation among banks in terms of credit lines may be more significant than the minimal tiering in deposit rates. As the study group's survey confirms, banks in the market typically establish daily and overall limits for the funds they will place with (loan to) other banks. These are usually not disclosed, committed lines but are internally imposed limits set by credit officers as parameters for bank traders.

Risks and Concerns

There are two levels of risk associated with the market — risk for individual banks based on their particular characteristics and market activity and risk for the system as a whole. First, since banks participate on both sides of the market, they are confronted with both credit and funding risks. Second, and more importantly, there is an underlying concern that because of the interbank linkages even sound banks might not be immune from a problem caused elsewhere in the system because of the knock-on effect. In the case of the UK fringe banking crisis of 1974, even perfectly sound banks suffered.

The above-mentioned survey by the Group of Thirty showed that a majority of banks feel that interbank activity may be becoming more risky because of a change in the composition of the market (an increasing proportion of interbank borrowing being done by second and third tier banks). And bankers rated "unavailability of interbank funds" as great a potential threat to individual banks, though not to the system, as "default by a major country debtor."

The concerns that have been articulated in the press and elsewhere can be summarized as follows:

- How have banks and bank supervisors responded to the funding risks in the market?
- Has risk in international banking increased because of growth in the interbank market? Do the inherent characteristics of the market contribute to its instability or stability?

Banking Practices

In the past, banks were "often prepared to lend on an interbank basis with relatively little financial analysis or personal knowledge of the borrowing bank . . . on the implicit assumption that a participant in the market possessed sufficient capital resources, support from stockholders (or parent bank) or a potential call on central bank assistance to be able to meet its obligations."[10] In the aftermath of the international banking crisis of 1974, banks began to review this assumption, tightening and improving their credit analysis practices, utilizing stricter limits and controls, and developing more direct personal contacts.

Many banks now treat deposit placement lines in the same way as credit lines, basing overall limits and individual transaction limits on assessments of creditworthiness, including consideration of country risk (99 per cent of respondents to the G-30 survey said that country risk played a significant role in determining interbank placement and credits).

Four factors may influence decisions. First, *financial statements* may be analyzed. Some banks do a careful analysis of even the largest banks, supplemented by visits by bank staff. Banks without the resources to collect and compile financial information themselves can purchase balance sheet and income statement data along with some standard ratios from several outside sources.

There are problems, however, in interpreting annual reports because accounting conventions and disclosure practices vary widely. For this and other reasons, banks themselves as well as some of the new credit information services, place a great deal of emphasis on a second set of factors. These are the *ownership* of a bank (and the nature of its relationship to its parent institution, if there is one) and the bank's *national support systems* — the quality and degree of bank supervision and consideration of lender of last resort facilities; 69 per cent of respondents to the G-30 questionnaire said that they evaluated the willingness of the other bank's government or central bank to come to its aid in adversity. Third, banks watch for *unprofessional* money market dealings and evidence of overtrading. (This, too has its limits since skillful liability management can hide problems, although for only a short time). Finally, banks, to varying degrees, strive for a qualitative *assessment of management*.

However, not all banks exercise the same degree of care. Some banks omit or do only a cursory analysis of the very largest banks; some apply general rules of thumb, e.g., considering the largest banks in the world or in any country to be unquestionably creditworthy; and others appear to rely heavily on the judgment of their correspondents. The G-30 survey provides some evidence to support the contention that some banks act on the faith that all the banks with which they place deposits are well regulated and will be backed up by their central banks, even outside the Group of Ten countries.

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[10] Steven I. Davis, *The Euro-Bank* (John Wiley & Sons, 1980), p. 76.

Although many banks assure the availability of standby lines (paying commitment fees for these when necessary), interbank lines are not always assured, and may indeed dry up for any individual bank when most needed. Many banks therefore take great care to maintain and test lines and cultivate overall relationships with other banks. Diversification of sources is clearly important. Banks employ various techniques to monitor their lines and try to gauge as well as possible how much they can tap from different sources and in different currencies and maturities. Additional business relationships may be developed to reciprocate for lines, and personal contacts may be deliberately cultivated as well.

Supervisory Practices

As with banking practices, it is difficult to make generalizations about supervision of banks with respect to their activity in the interbank market. Beyond qualitative supervision of bank practices, the capital adequacy and liquidity requirements or guidelines of bank supervisors would play a role in placing outside bounds on the aggregate level of a bank's interbank liabilities. (See Appendix D). About one third of banks responding to our survey reported that their home supervisory authority does not monitor their bank's international interbank lending and deposit placement activity.

Support Mechanisms and System Stability

The market as a whole has so far been resilient in the face of external shocks, as was demonstrated by the moderate reaction to the Iranian asset freeze. This may be partly because the breadth and depth of the international interbank market tend to limit the damage when funds are switched in response to a shock, because that causes no net loss of liquidity to the system. As a result, there is a greater chance for a reflow of funds (with adjusted rate differentials) as long as there is no generalized loss of confidence.

However, it is always important to prevent the spread of contagious mistrust. In the case of serious shock, smooth functioning of the market rests critically on a rapid restoration of confidence and may therefore, depend also on the assurance of adequate support mechanisms. The market's ultimate dependence on official support mechanisms is heightened by the nature of market relationshps. Since deposit lines are discretionary, some degree of credit rationing appears likely in a general crisis. To the extent that this occurs, banks faced with a sudden unavailability of funds and unable to obtain new funds by raising rates would be at least temporarily reliant on official support.

There are various forms official support may take — including lender of last resort and other, *ad hoc* arrangements. For the interbank market, the somewhat paradoxical role of these mechanisms in their dormant state, i.e., short of actually being called into action, is to maintain a degree of ambiguity as to when and under what circumstances an individual bank will be given support while at the same time sustaining confidence that shocks to the system will be controlled and neutralized. The ambiguity serves on the one hand to induce discipline on the part of market participants while at the same time fostering confidence sufficient to ensure that shocks will not trigger panic. Hundreds of new participants have entered the interbank market in recent years, many of them relatively small. The quality of supervision of a number of such banks from outside the major countries and uncertainty about access they might have to lender of last resort facilities in time of crisis leaves cause for concern.

Conclusions

The interbank market has functioned remarkably well; its considerable breadth, liquidity, and efficiency enable the international banking system to accomplish its enormous recycling task smoothly. The major change in the market is the proliferation in participants that has introduced second- and third-tier banks and banks from a number of non-GIO countries to the system. This bears on both the risks facing individual banks and the system risk and is the main reason why banks themselves feel that the riskiness of the market has increased.

It appears from the survey results that banking practices have changed in response, although the extent to which this is true is difficult to gauge. The treatment of bank deposit facilities as credit lines is a positive development; it is just as important for banks to perform careful credit analysis when lending to other banks as when lending to non-bank borrowers. Similarly, effective monitoring and management of funding risks are highly desirable.

For large, well known banks, taking interbank deposits may not present funding risks significantly different from other types of interest-sensitive, short-term liquid liabilities. However, smaller banks, newcomers, and banks without an established funding base are more vulnerable than the major multinational banks to increased tiering of rates or unavailability of funds in the event of a loss of confidence. The possibility of a re-emergence of steeper tiering or withdrawal of standby lines under adverse market conditions, which would naturally have a particularly marked effect on banks that are large 'net takers' of interbank funds, should add an element of self-discipline for all participants. Because of such considerations, and the lack of 'transparency' of the market — the difficulty in ascertaining the ultimate sources and uses of funds — reliance on the inter-bank market bank placements as a source of effective liquidity may be less than it appears to be.

It would seem appropriate for smaller banks and new entrants to the market to exercise special care and take a relatively more cautious approach to interbank funding, but it is not clear that all of them do so. The increase in activity in Euro-market brokers may reflect a relative increase in overall deposit-taking and placing by less well established banks, and funding obtained through brokers may be less reliable in times of difficulty because it does not carry with it the backing of business and personal relationships which many banks have cultivated.

It is worth emphasising that a bank is not necessarily a better or worse risk than any other type of borrower even though it is increasingly the case that supervisory authorities in each country pay special attention to the continued stability of such institutions. Decisions to extend credit facilities to, or place deposits with, a bank must therefore be made on an assessment of the quality of management and fundamental strength of the bank concerned, the economic and political condition of the country in which it resides and a judgment of the quality of supervision in that country. The willingness and ability to its central bank to provide "lender-of last resort" support in an emergency should not be taken for granted.

4. MATURITY TRANSFORMATION

While the practice of maturity transformation, namely receiving deposits at one maturity and lending at another, is an integral part of financial inter mediation, perceived changes in Euromarket conditions and practices have prompted renewed attention to the subject. On the asset side, a borrowers' market has at times produced a lengthening of maturities. On the liability side, typical OPEC preferences for short-term deposits have been reinforced by rising short-term interest rates which have induced other depositors as well to seek shorter terms.

Competition in loan markets has at times resulted not only in a lengthening of lending maturities, but also a shrinkage of loan margins, putting pressure for extra income on other bank activities. At about the same time, a shift in the U.S. approach to monetary policy, emphasizing management of monetary aggregates vs. short-term interest rates, was accompanied by great volatility of U.S. rates and hence Euromarket rates, making portfolio management more difficult. In 1980 and early 1981, substantial losses on mismatched positions were reported by a number of major multinational banks. Others, however, profited from the new volatility of interest rates. This greater volatility increases both the risks and possible rewards of mismatching.

It is important to try to distinguish the two components of risk in maturity mismatching — interest rate risk and funding (liquidity) risk — and to understand how Euromarket practices affect each. The interest rate risk component is to a great extent alleviated (but not eliminated) by floating rates and the rollover technique which pass interest rate risk on to the borrower. The effect in a period of rising interest rates is to increase credit risk. The extent to which a bank covers itself against interest rate risk depends for the most part on how closely it matches liability maturities to the rollover maturities in its assets. If a loan that is repriced every six months is funded with 30-day money, the bank's exposure to potentially adverse changes in market rates of interest is not fully covered. In addition, smaller, less well-known banks would continue to be vulnerable to increased tiering of rates even if liabilities were completely matched to asset rollover dates.

The rollover mechanism does not, however, neutralize funding risk — that is, the possibility that a bank may be unable to tap resources to meet its continuing obligations. For the market as a whole, supply and demand are kept in balance by interest rates; however, the market response for particular banks in different circumstances can vary considerably. Banks with established names can reasonably expect to tap even a large amount of funds, when needed, and at relatively advantageous rates. For smaller, less well known banks, particularly relative newcomers or ones without a connection to the U.S. dollar market, the funding risk may be a real one.

Bank Practices

In the 1970's many banks began to re-examine procedures for asset and liability management with an eye to greater global coordination. Most banks monitor their liquidity positions with some care. As in the case of foreign exchange positions, top management sets general policy for maturity mismatches and puts limits on discretionary decisions by lower managers, based on assumptions about movements in rates. The range of practical approaches to fund management runs from centralized global control to decentralized, local (profit center) control. Neither way is clearly superior; there are advantages and disadvantages to both. Banks' actual practices vary. About 40 per cent of banks participating in the G-30 survey indicated that they had reduced limits in reaction to greater risks posed by the current volatility of interest rates.

Supervisory Practices

Bank supervisors are aware of special problems in liquidity management that may arise from banks' international operations. But direct comparison of the approaches adopted by different supervisors is rendered very difficult by the variety of techniques used to measure "transformation" and wide institutional differences. It may be noted, that about one third of banks participating in the survey said that supervisors' performance in monitoring their mismatched positions was "poor" or "fair".

Because of the inadequacy of existing statistics, the Committee on Banking Supervision and Regulatory Practices under the chairmanship of Mr. Peter Cooke has been working to try to encourage and develop a uniform reporting system to be used by the BIS to collect data on banks' maturity mismatching, particularly with regard to their international business.

A number of supervisors (e.g., France, Japan) have increasingly urged their banks to fund a proportion of their long-term foreign currency assets with long-term foreign currency liabilities, partly at least because in foreign currency business, banks have no automatic lender of last resort to turn to who is itself the issuer of the currency in question.

Conclusions

Available maturity structure data make it impossible to reach any conclusions about whether the degree of mismatch has worsened. Efforts by bank supervisors to improve the collection of statistics of this kind are thus a positive development and for these statistics to be fully meaningful it is important that the coverage of data should embrace international banks' worldwide business.

Yet even if no worsening of trends on a consolidated basis has taken place most bankers and study group members believe that interest-rate volatility has tended to increase riskiness of traditional mismatch practices. This increased risk requires banks to be more cautious. Furthermore, of course, losses themselves will tend to have the healthy effect of inducing greater discipline in bank practices. Whilst banks' managements are responsible for their own mismatching practices, supervisors must also be concerned to ensure that these are prudently established and operated.

5. DISTRESSED BANKS

The growth of the international banking system has increased the potential range of problems created by bank failure. The problems of a single bank, unless contained, could have an impact through the international interbank market; banks and banking systems are always vulnerable to confidence crises. Moreover, the transnational structure of the international banking system and the potential global spread of contagion have enormously complicated the management and resolution of bank failures and distressed bank situations.

Three different cases of bank failures in the last decade illustrate some of the international ramifications such occurrences may have, not only the unfolding distress of the bank itself, but also the nature, extent, and timing of crisis resolution by national banking authorities.

- In June 1974, the Bankhaus I.D. Herstatt, which had incurred large foreign exchange losses, was abruptly closed by the German Federal Supervisory Authority for Credit Matters. The collapse of the bank shocked the markets, which had not previously demanded risk premia for interbank transactions. After the Herstatt crisis, rate tiering appeared, and many sound banks had difficulty getting access to funds simply on the ground of being small.

  In addition, by closing Herstatt at the end of the banking day in Cologne but just after the beginning of the banking day in New York where scores of Herstatt's foreign exchange contracts were in the midst of settlement, the German authorities inadvertently interrupted the international payments mechanism. Herstatt's principal New York clearing bank, Chase Manhattan, froze the account. Debit orders were not honored; credits coming in were not returned. A race for Herstatt's New York assets by its creditors from around the world ensued.
- At about the same time as Herstatt's problems were becoming more visible in the spring of 1974, U.S. banking authorities were in the midst of a protracted attempt to prevent the collapse of Franklin National Bank, then the 20th largest bank in the United States. A decision by the Federal Reserve Bank of New York to provide emergency liquidity assistance in substantial amounts had as one of its two main objectives prevention of "the severe deterioration of confidence, at home and abroad, that would have resulted from an early failure of the bank." (Federal Reserve Bank of New York, Annual Report, 1974.)

  The same concern for international market stability, which was shared by other central banks as well, also prompted the Federal Reserve to acquire Franklin's foreign exchange book when the market, fearing the bank would fail to perform on contracts, began to refuse to sell foreign exchange to Franklin.

  Because Franklin had a large London branch, management of the problem required the Bank of England's cooperation at two junctures. First, during the months of liquidity assistance, the steadily increasing need for collateral for Franklin's borrowings from the Federal Reserve required the use of assets at the London branch. Second, the ultimate solution, a purchase and assumption transaction, required that the Bank of England help to secure the necessary approvals under English law for transfer of Franklin's London assets to the FDIC which acted as receiver prior to the sale to European-American Bank.
- In the spring of 1980, Argentina's Central Bank ordered the liquidation of Banco Intercambio Regional (BIR), the country's second largest private bank. The exposure of foreign banks was about $80 million. Foreign

currency deposits were not covered by Argentina's deposit insurance plan. Moreover, Argentinian authorities, claiming lack of authority, refused to accept responsibility for claims on BIR's New York branch. The New York State Banking Department took possession of the branch, hoping to be able to pay off depositors and creditors by selling branch assets.

The liquidation of BIR triggered a run on deposits at other Argentinian banks. The Argentine Central Bank was forced to inject an estimated $2 billion to avoid a collapse of the private banking system. In the meantime, the country's $10 billion accumulation of foreign exchange reserves had begun to drain away, leading some concerned observers to worry about the adequacy of Argentina's resources to meet a potentially prolonged banking crisis.

Concerns

Concerns about distressed banks and their impact on the stability of international financial markets spring from perceptions of the large degree of interdependence among banks from all over the world and market doubts about the ability of existing lender-of-last-resort facilities to manage and contain future crises of potentially global proportions.

A majority of bankers participating in the G-30 survey expressed their agreement with the proposition that "the international banking system would be vulnerable to a chain collapse in the event of a crisis affecting a significant bank or group of banks", although supplementary comments suggested that they considered this eventuality to be improbable. More than two-thirds said, however, that there was "a need for clearer understanding of lender of last resort facilities."

Two distinct lines of questions are raised by such firm comments:

- Do individual national authorities have the capacity (powers, resources, judgment) and willingness to act to avert an international crisis?
- Given the complex transnational structure of the international banking system, is there sufficient clarity of responsibility, i.e., which central bank is responsible for which banking institution?

Crisis Management Mechanisms

The organization of nations' crisis management systems reflects different national legislation and policies. In the United States and a few other countries, rescue responsibilities are divided among the institutions that respond to illiquidity and those that deal with insolvency. The distinction, of course, is not easy to draw, and interaction of the two functions is sometimes required to meet emerging problems. In some countries, the central bank has responsibility for handling crises both of illiquidity and of insolvency, though this is by no means true of all. However, in some of the latter countries there are other institutions for dealing with insolvency.

Crisis management mechanisms may take a number of forms, including lender of last resort facilities, deposit insurance and *ad hoc* arrangements. Regardless of the original source or nature of an individual bank's problems, what triggers a crisis of confidence for the whole banking system is a liquidity crisis. In order to stave off or contain such a crisis, authorities must be able to provide needed liquidity quickly to avoid a panic run on deposits. Hence debates about dealing with distressed banks in an international context have tended to concentrate on lender of last resort facilities.

In the classic view, a lender of last resort is an institution which has the responsibility to provide the residual liquidity needs of the financial system rather than to specific institutions. These may arise in day-to-day activity or in emergency situations. In the latter case, the lender of last resort may prevent and neutralize the impact of financial shocks by lending to institutions during periods of crisis and by acknowledging its duty to lend in the future. In fact, the presence of a lender of last resort alone may be sufficient to sustain public confidence.

At the same time, the efficacy of lender of last resort and other kinds of support arrangements requires that they should not be viewed as providing an unconditional guarantee. Such a guarantee would have the perverse effect of encouraging some banks to take undue risks in the belief that if they got into trouble rescue by national authorities was assured.

The development of lender of last resort facilities and other types of crisis management mechanisms is closely related to the degree of maturity of a country's banking system. Such facilities are usually not questioned for the G-10 and other industrialized countries. However, as already noted, the increasing participation in the international system of banks from developing countries has given rise to some unease, in large part because the quality and commitment of their national support arrangements are not clear.

The transnational structure of the international banking system poses additional questions of access to lender of last resort facilities for several types of banking institutions. These include foreign subsidiaries and participations and sometimes even foreign branches which, in a crisis, may be unable to obtain access to their parents' lender of last resort. Increasing numbers of multinational consortium banks add their own element of uncertainty.

The Response of Banks After Herstatt

Since 1974, the behavior of banks in the interbank market has reflected varying perceptions of the support that may be made available to a distressed bank. Some banks treat possible unwillingness or inability of a central bank to support its national banks as part of country risk and may extend or withdraw credit lines as their analysis of circumstances dictates

(See answer to Question 50 in bank survey). Such analysis may include attempts to determine whether rescue efforts might be forthcoming only for large and/or government-owned banks. Once a bank is actually known or believed to be in distress, continued extension of credit from other banks rests on the belief that the authorities will provide support. Some banks will then continue to lend in an effort to maintain confidence in the system and avoid crisis while others withdraw deposits or lines; some banks that continue to extend credit may be additionally motivated by the opportunity to take advantage of relatively high rates and the hope of benefiting, over time, from having proved themselves "friends in need".

The Response of Major Central Banks

With the events of 1973 and 1974 as a catalyst, recognition of the potential need for concerted action in the event of international problems was considered at a meeting of the world's major central banks in Basle in 1974. The statement they issued reflected the classical model, that is, public concerns should be put to rest with assurance that support is available but, in order to keep the markets disciplined, the exact circumstances under which support would be forthcoming should not be formally specified. Specifically, the Governors of the G-10 and Swiss central banks announced that, after considering the problem of lender of last resort in the Euromarkets, "they recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity." But they were "satisfied that means are available for that purpose and will be used if and when necessary."

Conclusions

The study group believes that some degree of ambiguity is a necessary feature of a lender of last resort facility. Any move to spell out specific terms and conditions under which assistance would be made available to banks in distress would have the detrimental effect of undermining market discipline. At the same time, the strong views of commercial banks that there is a need for clearer understanding of lender-of-last-resort facilities were noted.

6. COMPETITION, PROFITABILITY AND CAPITAL

In explaining the narrow spreads on international loans bankers give greatest weight to supply and demand conditions and to aggressive pricing by lenders seeking to enter new markets or expand market share. The entry of new banks into the Euromarket and expansion of international activities by previously established institutions have obviously maintained intensely competitive conditions. For example, data on syndicated loans collected by the World Bank suggest that there may be as many as 10 times the number of lending institutions in the syndicated loan market today as there were in 1972. Of those that the World Bank identified by name (institutions in the first nine or ten manager positions), one-third of 1980's syndicated loan managers are headquartered outside Europe or North America, compared to only one-eight in 1973: See Appendix C.

Concerns

Perceptions of increasing risk in international lending are frequently accompanied by concern that, with spreads on loans squeezed by intense competition, returns are not commensurate with risk. Moreover, there is concern that the narrow margins lead to lower profits, thus impairing banks' ability to maintain adequate capital ratios.

The remainder of this section will explore the following questions:

- What is the relationship between quoted spreads and bank profitability?
- How have banks responded to narrower margins?
- Does competitive pressure come particularly from some banks with competitive advantages?
- What has the supervisory response been?

The Effect of Spreads on Profitability

Quoted spreads are a guide to establishing borrower costs, not measuring profit margins, if only because banks' average costs of funds are usually below LIBOR, front-end fees on loan agreements provide further compensation and there is the unquantifiable benefit of other business kept or gained.

In general, large banks enjoy wider gross lending margins because of their lower average cost of bought-in funds. They and banks that take lead roles are more likely to gain more also from fees and related business. Participants that do not have such advantages — or have them to a lesser extent — have some offsetting benefit, however, since they do not incur as much indirect (non-funding) costs as the lead banks.

The question of what level of spreads is "acceptable," i.e., likely to generate an adequate net return, is a very difficult question for any individual bank. Analysis of the profitability of international lending, and international operations generally, poses problems which include allocating indirect costs. It has been reported that many bankers have been dissatisfied with their own internal data and profit-center analyses. The difficulty of accounting for the true economic cost of rescheduled loans, discussed earlier, further complicates the issues.

Follow-up interviews to a previous Group of Thirty survey yielded some "guesstimates" on profitability from non-U.S. banks. Most estimated their true gross return at about *0.25 per cent* above quoted spreads. Also, most estimated their breakeven point at about 3/8 per cent over LIBOR plus some elements of front-end fees.[11]

The record shows that individual lenders are not able to stop the erosion of loan spreads. Since banks feel in many cases compelled to maintain market presence, the principal results of a bank's attempt to hold the line at a given "acceptable" spread may be a deterioration in the quality of its loan portfolio.

Sources of Pressure on Margins

Some banks have competitive advantages that arise from the regulatory regime within which they operate. Highly leveraged banks can lend at relatively low margins and still earn a reasonable return on equity. Also, because there is less emphasis on profitability, some government-owned banks or savings banks may have a similar pricing advantage. Finally differences in reserve requirements and other regulatory measures can also have an impact on competitive abilities of banks, especially if they were to be manipulated to promote or discourage international activities.

However, not all competitive pressure comes from banks with regulatory advantages. For example, sluggish domestic loan demand may lead to more aggressive pricing by banks from different countries at different times. Also, more recent entrants may at any given time be competing more aggressively to gain market share or carve out a special niche. Finally, even the more established institutions may adopt a competitive strategy of cutting price to increase market share. Waves of intense competition from various groups of banks tend to maintain the pressure on margins.

Such competitive pressures in the market are expected to continue. The bank survey identified varying capital requirements as the main factor distorting competition, in the view of bankers. Differences in regulation were thought by a majority to be "somewhat" important factors affecting competition.

Supervisory Capital Requirements

The continuing decline in spreads, since 1976, in spite of some recent recovery, and perceptions of increased risks in the market, has prompted special attention to capital adequacy on the part of banking supervisors from the major industrialized countries. Germany and Switzerland, for example, have recently widened the scope of their capital requirements in order to encourage their banks to increase provision for the risks they incur in their international activities. A brief outline of capital adequacy requirements is given in Appendix D.

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[11] "The Outlook for International Bank Lending", G-30, August 1981. It should be noted that these guesstimates were highly qualified since many respondents indicated they are not able to monitor efficiently their marginal cost of dollars, and most admitted that inability to allocate overheads, etc., made costing unreliable.

To the extent that capital requirements are effective, they should ultimately constrain expansion of lending when returns are inadequate. Reportedly, some Swiss and German banks have reduced their international lending activity in reaction to new or proposed requirements, and some banks in London claim to have been constrained by Bank of England capital adequacy guidelines, although it is not clear whether this has had any direct impact on their international business. A previous Group of Thirty survey revealed that respondents' banks believe capital adequacy will be one of the more important constraints on future international lending, although not necessarily a very significant one.

The BIS, in its April 1980 communique, listed capital adequacy as one of the three elements of international banking soundness to which the central bank governors attach "cardinal importance", and endorsed the efforts of the Cooke Committee in this area. It seems likely pressure by national authorities to sustain adequate levels of capital will continue, and will be beneficial for the protection of the earning capacity of the international banking system as a whole. This may be accompanied by some move towards convergence of different countries' capital adequacy standards, although this is likely to be a fairly long-term prospect.

Conclusions

It is the opinion of the study group that supervisors should not attempt any direct action to increase loan margins. There may in any event be practical limits to the efforts of individual supervisors, because of possible disadvantages to their banks from prudential requirements that are significantly more stringent than their competitors'. For that reason, cooperative efforts among supervisory authorities are a very positive development. The bank survey revealed support for the view that requirements should be harmonized — with a preference (perhaps not surprisingly) for achieving this by reducing rather than raising regulatory requirements.

7. FURTHER SUGGESTIONS FOR REDUCING RISKS IN BANKING

The purpose of this concluding section is to explore two suggestions for reducing risk — through a requirement for banks to make provision for rescheduled loans and, secondly, by way of improving the arrangements for dealing with rescheduling and the flow of information on international indebtedness. These are in addition to the recommendations made in the preceding sections of this report.

Provision For Rescheduled Loans

A recently topical subject has been the question of whether banks should be obliged to make provisions against loans that are to be rescheduled. The question is whether regulators ought to move towards requiring the making of some provision against a portion of rescheduled loans at the time of rescheduling. To put it another way, rescheduling — de facto — indicates the existence of a loan quality problem. Even if this problem is presumably resolved through an agreed rescheduling, there is no reason to doubt that the lending institutions' judgment at time of loan origination had not been borne out. Consequently, provision against possible loss or a provision for opportunity-loss seems prudent and reasonable. It is the opinion of the study group that, as reschedulings may become more common, it would be in the interest of banks to make some provision against rescheduled debts either specifically or through the existence of some general provision of adequate size and, unless circumstances are exceptional, supervisors should encourage action on these lines.

Those who argue against this point of view note the following:

1. There is little international uniformity in the treatment of non-performing and rescheduled loans. Obviously, the inequity posed by differing rules and differing standards can be used as an argument to frustrate the basic concept of provisions for rescheduled sovereign loans. However, individual regulators could proceed along lines they deem to be best for the safety and soundness of their banking system even if other regulators are more lenient.
2. A second argument is that the requirement for rescheduling can be solved by bank refinancing. Rescheduling might be avoided by increasing loans to cover interest and/or principal payments. This technique is obviously nothing more than putting off the day of reckoning; it amounts to the same thing as a rescheduling and lacks conviction.
3. A third argument in opposition to provisioning has been that it weakens creditors' negotiating position and might tempt debtor nations not to fulfill their obligations, although there is little evidence to suggest that this has been a feature in rescheduling activities to date.

On the positive side, the argument for provisioning is that:

1. The rescheduling is, in and of itself, an indication of loan-quality problems. Such quality problems should be recognized and some portion of the rescheduled loan should be reserved both as an indication of the reality of the loan quality problem and also because of the costs involved in rescheduling, not the least of which is the opportunity cost.
2. Provisioning reinstills into sovereign lending one element of discipline

> which may have diminished substantially over the past decade as losses in international lending have been contained due to rescheduling activities.

Clearly, the problems concerning provisions for losses and rescheduling activities are substantial. On the other hand, a more rigorous approach could help improve discipline within the international banking system. In addition, it would discipline the sovereign borrowers and strengthen forces making for better balance of payment adjustments. In sum, the study group believes that it is appropriate for all supervisory and regulatory authorities to encourage banks to take action in this area, although it is recognized that it is unlikely that this will be possible at least initially in any uniform way.

Inadequacies of Existing Arrangements

The study group feels that the existing arrangements among banks to deal with country debt reschedulings are unsatisfactory, being almost entirely of an ad hoc nature. In particular, the period leading up to renegotiation has been extended, to the detriment of all parties, by the need for lending banks to be persuaded to join together, pool information and appoint negotiators (recent experience has shown that it can take a long time before the major banks even know what other banks are involved). Also, the study group notes that the assembly process in respect of gathering information on cross-border claims of commercial banks is incomplete and needs to be improved.

A good example was that of Turkey where the first estimates of lending proved to be far lower than the total which emerged when banks and other creditors revealed their individual lending figures. The same happened in the case of Poland. The study group feels that it would be in the best interests of both debtor countries and creditor banks if it were possible to have a central unit in which statistics on international lending were kept complete, up-to-date and confidential. This might be undertaken by the BIS, building on their existing work, or conceivably by a new organization established by the banks themselves.

Clearly, the combination of a prolonged recession, falling commodity prices and historically high levels of real interest rates in most major countries and especially in the United States could lead to further strains appearing in the banking system, especially if a number of reschedulings were to take place either simultaneously or within a short space of time. It might well be that the banks would react to an increase in perceived risk by cutting back international lending. If the same phenomenon applied to the inter-bank market, an individual bank could find it difficult to renew deposits in the inter-bank market, thus setting off a contraction in liquidity. While these risks exist whether arrangements for rescheduling of country debts are efficient or inefficient, the study group feels that the level of risk is unnecessarily increased because there is no generally accepted and readily activated mechanism for dealing with a potential escalation of such problems. By contrast, it was noted that in the case of official government creditors, once a country finds itself in difficulty, the Paris Club can be convened and the government creditors are able to react quickly and in unison to a common problem.

The same point applies to relationships between commercial banks and the International Monetary Fund and the World Bank. No formal (or even informal) system exists whereby representatives of commercial banks as a group and officers of the International Monetary Fund can meet regularly to discuss mutual problems. Naturally, the study group recognizes that the IMF and the World Bank would find it difficult, if not impossible, to initiate discussions with commercial banks on country problems for fear of being accused by member countries of favoring such creditors. However, it is felt strongly that this legitimate concern does not obviate the need to establish means of better communication. The overriding consideration is to establish a method or forum whereby the major actors in international lending, namely the commercial banks, the multilateral official institutions, and government creditors could find a way of working more closely with each other and with borrowers both to improve the flow of information and to react quickly in case of need.

A Consultative Group for International Banking?

The study group felt that the more rapid the action of the main actors in dealing with a debt rescheduling need, the more likely would it be that a country could resolve its problems in a timely manner without being subject to a precipitous withdrawal of credit and hence possibly unnecessarily severe domestic economic adjustments. Among various ways in which such prompt action could be encouraged the study group gave close consideration to initiatives that might be taken by the private sector of the international financial community.

One area in which further improvement is required, as noted previously in this report, is in the collection and timely dissemination of statistics on the liabilities of countries to the banking system and capital markets.

Data on international bank lending is already gathered by the World Bank and the Bank for International Settlements, but a banking bureau which could supplement information from such sources by obtaining additional information from borrowers or lenders could play a useful role in increasing the 'transparency' of the market (for example, by gathering information on the exposure of banks from different countries to particular sovereign borrowers, lending by banks outside the Group of Ten and

Switzerland, the positions of official and other non-bank creditors, and movements in short-term credit flows).

Beyond such initiatives to improve information could come the establishment of some forum (an "International Banking Consultative Group"?) in which leading international bankers would be able to discuss issues of mutual concern. It might also be able to liaise on behalf of bankers with official international and government agencies, providing these bodies with an additional forum for discussing problems concerning international capital flows and market regulation. Equally important, it would be available as an additional channel through which borrowers would be able to convey their views more effectively to the international banking community at large.

This role as a "channel of communication" might over time be found particularly useful in connection with international debt servicing problems. The body could not itself represent banks in rescheduling negotiations, but could in certain circumstances occupy a liaison role between bankers and borrowers, and between different banking interests in a problem loan situation. The possibility of conflicts of interest must be acknowledged, given that the group would be composed of bankers who are themselves active in the international field, but the group would be in a good position to look beyond such interests and focus on factors of longer-run importance.

Past experience has shown that debtors as well as creditors have much to gain from improvements in the machinery for dealing with debt problems. It would be for the "consultative group" to demonstrate through its actions that its role is a constructive one, and not narrowly sectoral in outlook. It could provide the means for bringing involved banks together quickly once a rescheduling request had been received, and in due course could be expected to develop expertise that would be of great assistance to negotiators of both parties. A "consultative group" could not, of course, have legal powers to enforce decisions, but would derive its authority from the standing of its members, the expertise of its secretariat, and from the moral support given to its work by the international banking industry. It would certainly be important to discuss the objectives of the new body as widely as possible, to demonstrate the positive role it is intended to play, and to take full account of the views of sovereign borrowers.

New patterns of international financial flows will be called for in carrying through the volume of international lending needed in the 1980's. These may include expanded use of co-financing, parallel lending and similar techniques. Progress in these directions, which has so far been disappointing, might well be facilitated if there was in existence an authoritative body amongst commercial bankers with which the international agencies could co-ordinate their thinking and establish acceptable ground rules for co-operation and joint development.

The study group fully recognized that there are likely to be many difficulties in setting up such a group. For example, the question of whether members should be formally representative of their respective national banking communities or selected in another manner would require careful consideration. On the one hand, in view of the fact the Euro-currency markets have developed on a transnational basis and that sectionalization of interest along national lines could be counter-productive, it may well be best to avoid members being nominated by national banking communities. (There is also the possibility of anti-trust conflict to be considered, though this should not be exaggerated). On the other hand, national representation would provide a more formal element of structure to the Council and perhaps strengthen its moral authority.

More generally, these areas of difficulty might be found less of a problem if in the first instance an experimental body were to be established on an informal basis. It would then grow when experience was gained, thus helping to avoid the problem of unrealistic expectations, and by this means enjoy greater freedom to set a style for future operations. Private discussions indicate that a wide measure of support exists, both inside the banking industry and among interested outside parties, for the concept of a representative international body of the kind discussed in this paper.

APPENDIX A

Commercial Banks' Attitude to Country Risk Assessment

It is possible that the 1980s will see an increase in the number of countries experiencing difficulties in the servicing of their international debts. A system which aids the early identification of such countries must, therefore, be an essential tool in the effective management of a commercial bank's lending portfolio. Concomitantly, such a system can make an invaluable contribution to the formulation of a commercial bank's marketing plans by identifying areas with potential for profitable and creditworthy lending opportunities.

This appendix attempts to summarize the "state of the art" of country risk assessment within the commercial banks with the aim of stimulating discussion on the appropriateness of the banks' approach to selected risk factors and their evaluation. The approach adopted in this analysis has been to review a number of systems which have been employed or proposed for the evaluation of country risk and which have been outlined in various recent published articles and other material. The majority of these articles relate to specific systems which are actually in use in a major international bank. (For definitions of terms, see page 6, footnote 3).

Diversity of Risk Assessment Methodology

In 1977 the Federal Reserve's Committee on Foreign Lending examined the international lending practices of 46 member banks. The study revealed that all those banks had internal systems for monitoring and controlling foreign lending but there was substantial diversity in the level of sophistication of the techniques used.

Similar research undertaken by Eximbank in the same year confirmed the variations in the methodology adopted by banks in the evaluation of sovereign risk. The Federal Authorities introduced in 1978 a paper entitled "A New Supervisory Approach to Foreign Lending" which clearly indicated that they expected each system to exhibit general characteristics, including risk assessment based on reliable and up to date information.

In practice it is difficult to envisage how such uniformity can be achieved, particularly bearing in mind the diversity of existing systems and perhaps, more importantly, the complexity and attendant problems appertaining to country risk assessment. The main problems identified are outlined under the appropriate headings in the ensuing sections.

Key Factors and Common Elements of the Systems Reviewed

For the purpose of this review of country risk assessment, eleven systems have been analyzed. A list is outlined at the end of this appendix.

The eleven systems reviewed have certain broad common factors and, in our analysis, we have grouped these into economic and political/social factors. This grouping broadly mirrors the distinction embodied in the systems themselves, which differentiates between a country's ability to service its debts (as measured by economic factors) and the extent to which the ability to repay debts is affected by political considerations (political factors).

A schedule indicating the economic and political factors taken into account in the systems reviewed is shown on pages 45 and 46.

Economic Indicators

The economic indicators which emerged from the analysis as being fundamental to country risk assessment were:

- the debt service ratio, i.e., $\frac{\text{debt service costs}}{\text{export earnings}}$
- the balance of payments position
- the exports growth trend
- the level of internal economic growth expressed in terms of one of the major economic aggregates such as gross national product (GNP) or gross domestic product (GDP).

It is evident that export performance, and hence a country's ability and capacity to generate foreign exchange, is a crucial factor. Current and expected performance in this area must, therefore, be one of the essential indicators in developing a meaningful system of country risk assessment.

An important question therefore must be: how accurate and up to date is the available data on exports and the other factors with which it is compared for analysis purposes?

Exports

One of the main sources of information on exports themselves is the International Monetary Fund's monthly publication "International Financial Statistics" which provides a reasonably accurate current account position and balance of payments trend. In addition, because these statistics provide a break-down by major product, the dependence of a country's economy on selected exports is available.

External Debt

The availability and accuracy of information in respect of a country's external debt, and particularly its constituents, is a problematical area which in turn influences the reliability of the debt service ratio. If such information is not sufficiently comprehensive or accurate, then the reliability of this risk assessment tool is in doubt. This is clearly a matter of importance, since most of the systems reviewed in this paper make extensive use of this ratio in their evaluations.

Improved data, in isolation, would not, however, resolve the problems associated with projecting this measure into the future. These problems arise because predictions of the debt service ratio should include assumptions concerning future interest rates and the levels of future borrowings.

The latter is calculable by reference to projected future balance-of-payments deficits and the extent to which these will be financed by increased borrowing. However, it is open to question whether this approach is satisfactory because assumptions concerning increased borrowing automatically imply that a country is creditworthy — the very fact which the analysis (including projected debt service ratios) is seeking to determine.

It must also be borne in mind that, to satisfy their borrowing requirements, certain countries could be recipients of loans at favorable interest rates and/or terms ('soft loans') akin to aid which would distort projected debt service ratios.

Similarly, the problem of the accurate prediction of interest rates cannot be easily resolved. The volatility of US interest rates over the last two years is clear evidence of this. Therefore, a relevant question is how the quality of the data necessary to formulate accurate projections can be improved.

Major Economic Aggregates

The data on which measures of growth in GNP and GDP are calculated emanate primarily from World Bank sources and, like the debt figures, suffer from production delays.

Despite the fact that a country with a rapid growth rate would appear to be a sounder economic prospect than one with a contracting economy, experience tends to show that there is little apparent connection between risk and either GNP/GDP totals or growth rates in these aggregates.

The question must, therefore, be asked: why are such indicators, which correlate poorly with historic rescheduling experience, often included in risk assessment systems? Is it because they are generally accepted as the most important indicators which modify the overall view of a country as presented by the export related indicators? If so perhaps these indicators should be seen as a checklist of the thoroughness of the assessments made in arriving at a country's likely export performance.

Other examples of such modifying indicators include:

- the inflation rate,
- the growth in a country's capital stock as measured by the level of gross capital formation,
- the economic diversity within a country,
- money supply growth rates.

Overall one could speculate whether, in fact, these qualitative indicators do contribute to the operational success of an economic analysis system. If it can be shown that they do not contribute, could the argument be advanced that the examination of factors, other than those relating to exports and indebtedness, is unnecessary?

Political Indicators

The need to define terms clearly is even more imperative when considering political factors. However, it is possible to identify two main groups of factors which are felt to be fundamental to the assessment of political risk.

These are:

- the factors which indicate the ability of a political system to accommodate change without serious disruption, and,
- the factors which identify factions within a political system which may seek to cause disruption as a means of change, either on religious, political or ethnic minority grounds.

Both these groups of factors relate to the political stability of a country with particular reference to its prospects for the future, this being felt to be the main aim of any political analysis.

It is , however, pertinent to emphasize at this juncture that, during the 1970s when the level of international lending substantially increased, the incidence of ultimate loss from state risk lending was minimal. This cannot reasonably be attributed to a high level of political stability during this period. Rather, experience has shown that no country can completely isolate itself from world events and that whatever local circumstantes may prevail, it must maintain certain standards which include the honoring of international commitments if it wishes to continue to enjoy commercial links with other states and institutions. A recent example as far as the commerical banks are concerned is Iran. It has repaid the majority of its international debts although it is recognized that certain other obligations remain outstanding.

The question may, therefore, be asked: in what way is the analysis of political stability generally relevant and necessary within a country risk assessment system?

The question need not infer that political analysis is totally without use but implies, as in the case of the qualitative economic indicators, that the aim of any system may be not so much to avoid situations of absolute default but to identify and hence minimize the risk of temporary disruption and of rescheduling.

Systems Used to Combine Economic and Political Indicators

One of the main problems associated with these methodologies is how to combine the two elements in one assessment, and in this regard, the inter-relationship that inevitably exists must be borne in mind.

This inter-relationship means that, in combining economic and political factors into an overall country score, care must be exercised not to recount, under political variables, those already fully reflected in the economic score.

Commercial banks have not been deterred, however, from seeking systems which take into account both types of factors in establishing an overall rating.

In analyzing the manner in which the systems used by banks combine economic and political indicators to arrive at a country risk rating, it is interesting to note that all the systems surveyed gave details of economic factors used in the systems but only eight gave details of political influences.

The manner in which credit risk assessment is practiced in any one of the institutions surveyed is influenced by the following factors:

a) the size of the institution and the level of expertise;
b) the involvement of the institution in the international lending market:

The nature of the analysis undertaken has inevitably meant that it has concentrated on larger institutions with significant presences in the international lending market. Because of this, it was to be expected that the commercial bank systems reviewed would exhibit relatively high levels of sophistication.

The majority of banks have concluded that an approach combining statistical analysis with a more descriptive method, and covering both economic and political factors is best suited to their needs. This method, known as a "structural/qualitative" approach, recognizes the limitations of both a purely statistically based system ("checklist" approach) and the shortcomings of the much looser "unstructured" approach or the exclusively "qualitative" approach.

The Place of the System in the Decision-Making Process

The Aim of the System

The general aim of the banks whose systems were reviewed has been to produce a system capable not only of identifying possible future defaults or reschedulings but also to aid the evaluation of the risk/reward relationship of any particular country. As already indicated above, this latter aspect is particularly relevant in the formulation of a commercial bank's marketing strategy.

Thus, as well as being one of the management tools used when assessing individual loan propositions, a country risk assessment system has an important role in the setting of country limits and the making of investment decisions. However, other important factors need to be taken into account such as the rate of return, strategic marketing decisions and lending portfolio considerations.

Whilst it is self-evident, it is important to stress that, for a risk assessment system to achieve its objectives, those operating the systems must fulfil these three conditions:

— they must possess an in-depth country knowledge,
— they must have a full awareness of those factors inherent in a successful country risk assessment system,
— they must possess the expertise necessary to identify and use the relevant data and, equally important, they must be able to analyse and interpret the conclusions in a constructive and balanced manner.

Other Considerations

Before examining other factors which will influence country risk assessment, it is worth noting that the systems reviewed are more applicable to the major international banks. It is nevertheless essential that all banks arrive at an independent judgment on all syndicated lending decisions and in this connection, lead managers generally incorporate into loan agreements a clause stating that participating banks are solely responsible for undertaking their own independent appraisal of the risks appertaining to a loan.

Some other considerations relevant to the risk/reward relationship are:

- — the frequency with which a borrower approaches the market,
- — the skill of the negotiators — both lenders and borrowers,
- — a commercial bank's existing exposure to a particular country and its need to maintain a balanced lending portfolio. Indeed this is one of the crucial factors and the principles of balance will be maintained irrespective of the assessment of country risk.

Future Prospects

The early 1970s was a period of growth in the Euromarkets and, during this time, as the number of banks involved in this sector increased and international liquidity expanded, most countries were able to fund even debt servicing by expanded borrowing. If this was not possible, countries were able to reschedule their loans in all except the very worst cases. As a result of these conditions, and the attendant low level of losses, there has been little apparent urgency to develop sophisticated systems because it has been possible to operate successfully without any formal system for minimizing country risk other than a balanced lending portfolio.

In more recent years, however, the influences of diminishing margins, at least in terms of prime borrowers, the slow down in the rate of growth which reduces demand from the corporate sector in the industrialized countries, and increasing competition for loans to the "better risk" developing countries, have combined to force banks looking for profit to turn towards "second tier" borrowers. This has occurred at a time when, for many countries, conditions have been worsening as the impact of rising oil prices, falling commodity prices and high interest rates has been felt.

There is no evidence that this trend in events is likely to alter dramatically. Banks are now being required to manage greater risk in their portfolios, and to seek more aggressively for satisfactory returns. It may, therefore, be expected that country risk analysis will continue to increase in importance.

Nevertheless, the quality of any system of analysis will still be dependent upon the standard of information which is input. In this regard, the World Bank, for example, is continually seeking to upgrade its information on countries' debt.

This is not to say that systems will necessarily monitor more variables: rather, that the standard of forecasting and understanding of each variable's significance should become better developed. There could also be a move towards more sophisticated models based on covariance at least for asset allocation purposes. This will involve a global approach to country risk, evaluating world events in terms of their overall effect on a portfolio of borrower countries.

Key Factors in Future Risk Assessment

Since Cuba and Ghana in the 1960s, no major borrowing country has deliberately repudiated its international debt, and this has led to the assumption, which was previously alluded to in this paper, that economic factors are paramount in assessing country risk. It may be that this assumption will gain further support and possibly, in future years, systems should focus even more on the economic factors. This is not to say that in future there will be a dramatic slackening in the pace of state risk borrowing.

The view is not, however, universally held, and it is not impossible that changes of regime in certain developing countries could conceivably lead to a repudiation of debts incurred by previous administrations.

Indeed, in view of the comparative sophistication in economic modelling and the fact that current political assesssments are adequate for most normal situations, it could be that this aspect of unpredictable repudiation of debts could become the greatest absolute threat to international lenders in the future. An ability to assess this kind of risk will depend on an enhanced level of political analysis, including major studies of opposition groups in many countries.

When undertaking state risk lending internationally, banks expect to be repaid on schedule either by the borrower generating sufficient foreign exchange or by refinancing its debt. In a large number of countries, the level of external debt is relatively small in terms of the overall size of the economy and, therefore, repayment or refinance presents little problem.

However, if balance of payments deficits persist in certain instances the level of external debt and the burden of debt servicing will continue to increase and will become major problems. In cases such as this where, at the current time, a country is experiencing difficulty in servicing its debt from foreign exchange earnings, its ability to refinance existing debt depends upon it being seen to be moving progressively towards the required level of foreign exchange earnings. Therefore, it is at least arguable that future risk assessment systems should develop further the capacity to monitor countries' progress in this respect.

NOTES

Definitions Relating to Country Risk Assessment Systems

UNSTRUCTURED APPROACH

This approach involves no systematic or regular analysis of a country's position but relies upon opinions held on each occasion when a decision as to the creditworthiness of a country is required. There is no attempt made to 'rank' countries or to assess relative risk/reward ratios.

CHECKLIST APPROACH

This approach involves using a 'scoring' technique to scale a country's performance with respect to prespecified variables. It is quantitative in character and suffers from the exclusion of other variables which may have relevance to the overall assessment.

QUALITATIVE (OR DESCRIPTIVE) APPROACH

This system, based on country evaluation reports which vary in detail from country to country, focuses on each country's unique attributes and problems. The principal disadvantage is that evaluation may vary substantially between countries making comparisons difficult. Moreover, evaluations tend to be retrospective rather than prospective.

THE STRUCTURED/QUALITATIVE APPROACH

This approach uses a standard format for all countries, thus facilitating comparison, it covers both political and economic factors and involves a degree of statistical analysis where appropriate. Because it relies not only on statistical data but also on expert opinion it is able to combine the advantages of the Qualitative with statistically based methods such as the Checklist Approach.

COVARIANCE

This will involve a global approach to country risk, evaluating world events in terms of their overall effect on a portfolio of borrower countries. For example, an oil price rise, whilst of benefit to OPEC countries, has a detrimental effect on the non-oil LDC's.

COMMERCIAL BANKS' ATTITUDE TO COUNTRY RISK ASSESSMENT

SCHEDULE OF FACTORS USED IN THE INDIVIDUAL SYSTEMS REVIEWED AT APPENDIX II

	Systems Reviewed (see key at foot of page)										
Measure~	**A**	**B**	**C**	**D**	**E**	**F**	**G**	**H***	**I**	**J***	**K**
Debt service ratio	X	X	X	X	X		X	X	X	X	X
Imports/Reserves ratio	X			X		X		X	X		X
Capital/Debt ratio	X			X		X		X		X	
Income per capita	X	X	X	X				X	X	X	X
Income growth rate	X	X	X		X	X	X	X	X		X
Export growth rate	X		X	X	X		X	X	X		X
Export analysis		X	X		X	X	X	X	X	X	X
Imports/Exports ratio		X	X	X	X	X	X		X	X	X
Economic diversity		X	X			X			X		X
Exports/GNP		X	X	X						X	X
Level of IMF support/Reserves ratio		X		X	X	X	X	X	X		X
Debt structure		X					X	X	X	X	X
Inflation/Monetary/Fiscal policy		X	X	X	X	X	X	X			X
Physical resources			X	X		X	X	X	X		X
Debt			X	X		X	X	X	X	X	X
Import analysis			X	X	X		X	X		X	X
Basic strength		X	X	X			X				X
Ability to change peacefully		X		X		X	X	X			X
Likeliness of internal conflict		X				X	X	X	X		X
Policies of ruling group		X	X			X					X
Philosophy of ruling group		X									X

COMMERCIAL BANKS' ATTITUDE TO COUNTRY RISK ASSESSMENT

SCHEDULE OF FACTORS USED IN THE INDIVIDUAL SYSTEMS REVIEWED AT APPENDIX II

Ability of government officers	X				X	X	X			X
Flexibility of the political system	X						X			
External relations	X				X		X	X		X
Minority groups	X	X		X		X		X		X
Religious problems	X			X		X		X		X
Unemployment	X	X				X				X
External ethnic problems	X		X			X		X		X
Government support		X				X				X
Type of system		X				X	X	N/A		X
Opposition groups					X	X		X		X
Wealth disparity		X				X		X		X

~ In some cases similar measures from two or more systems are grouped together under one heading. For example, "Income per capita and Income growth" are taken in terms of either GNP or GDP

* Systems H and J allude to a comprehensive political analysis but factors are shown above only where detailed in the articles.

KEY TO THE SYSTEMS REVIEWED:

A Feder/Ross: World Bank (G. Feder and K. Ross) 1977
B C.M. Korth, University of South Carolina, Ex First National Bank of Chicago 1979
C J.N. Robinson, Chase Manhattan Bank NA (1981)
D K. Janoeri, Union Bank of Switzerland (1980)
E Amsterdam and Rotterdam Bank NV (1980)
F Business International Country Risk Assessment Service (1981)
G P.S. Nagy, Bank of Montreal (1978)
H H.R. Heller, Bank of America (1980)
I P. Gutman, National Westminster Bank Ltd. (1980)
J American Express Bank (1980)
K A. Von Agtmael, Bankers Trust Co. (1976)

List of Systems Studied

1. *Authors:* G. Feder and K. Ross, Economists at the World Bank
   Article: Quantitative Creditworthiness Indicators are useful
   Publication: World Bank Publication.
   Date of Publication: December, 1977
   Aim: To quantify the probability that a country will reschedule at least part of its foreign debt in some future year.
   Indicators reviewed: Economic only

2. *Author:* A.W. von Agtmael, Vice President Bankers Trust Co. and Managing Director (designate) Thai Investment & Securities Co., Bangkok
   Article: Evaluating the Risks of Lending to Developing Countries
   Publication: Euromoney
   Date of Publication: April, 1976
   Aim: To analyse country risk from the point of view of a commercial bank making term loans to *developing* countries.
   Indicators reviewed: Economic and Social/Political

3. *Author:* C.M. Korth, Associate Professor of International Business, University of South Carolina (formerly Credit Analyst, First National Bank of Chicago).
   Article: Developing a Country Risk Analysis System
   Publication: Journal of Commercial Bank Lending
   Date of Publication: December, 1979
   Aims: To minimize the risk in a bank's foreign portfolio. (Risk in this instance includes default, moratorium, forced rescheduling or excessive delays in repayment of principal or interest on a national scale).
   Indicators reviewed: Political/Socio-Cultural and Economic.

4. *Author:* P. Gutman, Manager, Market Intelligence Department, National Westminster Bank
   Article: Assessing Country Risk
   Publication: National Westminster Bank Review
   Date of Publication: May, 1980
   Aims: Tc provide an assessment and classification of foreign countries from the point of a commercial bank involved in international lending.
   Indicators reviewed: Political and economic

5. *Author:* J.N. Robinson, Senior Economist, Chase Manhattan Bank
   Article: Is it Possible to Assess Country Risk?
   Publication: The Banker
   Date of Publication: January, 1981
   Aims: To identify countries which will fail to generate enough foreign exchange to service their foreign debt.
   Indicators reviewed: Economic and Political/Legal

6. *The Business International System* (BI)
   Authors: Business International
   Article: Business International Country Risk Assessment Service
   Article: Business International publication
   Date of Publication: 1981

Aims: To identify and quantify country risk in a system designed to meet the widest range of corporate planning and forecasting needs.

Indicators reviewed: Political, economic and financial

7. *The Amex Bank System*

Authors: Amex Bank Economics Unit

Article: Country Risk Analysis and Decision Making in an International Bank. The Approach at American Express International Group

Publication: Amex Bank Economics Unit publication

Date of Publication: January, 1980

Aims: To provide quality analysis of country risk, using all available resources and to thereby improve the bank's spread of assets world-wide.

Indicators reviewed: Economic and Political

8. *Author:* P.J. Nagy, International Economist, Bank of Montreal

Articles: a) Country Risk-How to Assess, Quantify and Monitor It
b) Quantifying Country Risk-A System Developed at the Bank of Montreal

Publications: a) Euromoney Publications
b) Colombia Journal of World Business

Date of Publications: a) December, 1978 b) Autumn, 1978

Aims: To quantify country risk by comparing the risks of investing in nations among which size, levels of economic development and political and institutional structures differ.

Indicators reviewed: Economic and Political

9. *The Amro Approach*

Article: Country Risk Analysis & Lending Policies — The Amro Approach

Publication: Amro publication

Date of Publication: February, 1980

Aims: A model to assist in portfolio development with regard to risk, return and volume.

Indicators reviewed: Economic and Politicai

10. *The Bank of America System*

Author: H.R. Heller, Vice President, International Economics, Bank of America.

Article: Bank of America's New Currency Evaluation System. (AMR — Euromoney conference on country risk assessment).

Date: 30 October, 1980.

Aim: To analyse a country's capacity to service its foreign debt.

Indicators reviewed: Economic and Political

11. *Author:* K. Janjoeri, Senior Vice President, Union Bank of Switzerland

Article: Assessing Country Risk

Publication: UBS International Banking publication

Date of Publication: June, 1980

Aims: To provide an indication as to the creditworthiness of any country to whom UBS may choose to lend.

Indicators reviewed: Economic and Political

APPENDIX B

The Rescheduling of Country Debt: Is a More Formalized Process Necessary?

Richard Huff

Introduction

With the growing importance of commercial bank lending in international financial flows in the 1970s, it was inevitable that country debt service crises would take on a new flavor. The debt reschedulings that resulted from such crises were not new or unprecedented, of course. Reschedulings of official debt had become fairly commonplace ever since Argentina had asked its government creditors to reschedule in 1956; ten countries engaged in 31 separate reschedulings over the two decades 1956—75. Such multilateral exercises had, in fact, become fairly routine through the procedures of the Paris Club, an informal group of major Western creditor governments chaired by the French Treasury.[1] And, while the rescheduling of debt owed to private creditors was less frequent, it was by no means unheard of; several countries — including Argentina, Brazil, and Chile — had rescheduled their private debt in the 1960s and early 1970s.

What distinguished the reschedulings of the later 1970s, then, was not so much their novelty as their scope. Instead of the relative handful of banks, often from a single country that once had been involved in negotiations, there were now 100, 200, or more. (Poland is currently attempting to reschedule debts owed to some 500 separate institutions.) And where a few million dollars were once at issue, the stake had grown to the hundreds of millions, or, in some cases, billions of dollars.

This increase in the scale of the reschedulings suggests a corresponding increase in their complexity — a complexity manifested both in the substance of the talks as well as the mechanics of a process involving so many participants. And it calls into question whether the ad hoc approach that has previously been taken toward the organization of these negotia-

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Richard Huff is Financial Analyst in the Strategic Analysis Division of the Office of the Comptroller of the Currency in Washington.

tions will continue to be effective in the reschedulings of the '80s. That approach, to be sure, has thus far been adequate to the demands placed upon it. No rescheduling talks have failed simply because of organizational difficulties in starting a new rescheduling process from scratch each time that banks and debtor governments decide to enter into negotiations. And the flexibility afforded by the absence of a more formalized process has perhaps aided in the resolution of difficult substantive issues.But "ad-hocery" has had its costs — notably the confusion and delay in resolving difficult organizational and procedural questions before substantive discussions can begin. And if reschedulings become more numerous and frequent in the years ahead — as many observers predict — it is well worth considering whether the process for conducting them ought to be more formalized and institutionalized.

This paper will examine that question. We will begin with a review of the rescheduling experience of the past half-dozen years, focusing in particular on whatever recurring problems and difficulties have arisen. The paper will then consider the coordination of commercial debt rescheduling with the renegotiation of official debt and the appropriate role of the International Monetary Fund. It will conclude with a brief discussion of possible improvements in the present rescheduling process.

The Rescheduling Process

Getting to the table. A recent IMF staff study[2] examined the cases of six IMF members that rescheduled their obligations to commercial banks between 1976 and 1980. It noted that the rescheduling process was generally a long and difficult one, taking from two to five years from the time a debt service problem first emerged until an agreement was actually signed. Generally, negotiations did not begin until one or two years after such signals as the emergence of arrears or the reluctance of banks to roll over maturing credits might have suggested that a rescheduling would be necessary; once begun, the talks themselves took anywhere from 18 months to four years to complete.

One of the difficulties the parties to these negotiations faced surely was the lack of a well established means of resolving their differences. "While the modalities for the restructuring of official debt were fairly well established," comments the IMF study, "the restructuring of debt owed to commercial banks involved, to a large extent, the breaking of new ground." Previous commercial debt reschedulings had concentrated on the restructuring of short-term trade credits, but now the focus was on medium-term syndicated Eurocredits, which brought a host of complications. The hundreds of banks of many different nationalities involved in the various loan syndications had to be contacted. Basic data on how much was owed to whom had to be collected, information that was not always readily available. (One country, which had not kept its records particularly well, had to resort to sending out a questionnaire to its creditors to find out exactly how much it owed.) And in four of the six cases covered in the IMF paper, the negotiations had to be coordinated with parallel discussions with official creditors, who insisted that private and official debt be rescheduled on "comparable terms."

Ultimately, though, despite such obstacles, the negotiations in each of the six cases were successful — at least in the sense of an agreement being reached and signed. (Whether the debtor countries will actually be able to adhere to the terms of these agreements is, of course, a separate question.) The actual hard bargaining was done by a steering committee of a half-dozen or so lead banks on the one side and representatives of the debtor nation (often assisted by investment bankers acting as advisers) on the other. Also playing key roles in the talks, generally as advisers rather than as active participants, were officials of the IMF, and, to a lesser extent, the World Bank. The members of the steering committee were generally chosen from the lead managers and agent banks of the syndicates that had lent money to the country; usually, these banks were the ones with the largest individual exposures. Additionally, steering committee members were chosen on the basis of country representation, so that a bank from each of the major creditor countries was present.

Interbank tension. After the steering committee members were chosen, they faced the sometimes-daunting challenge of forging a common negotiating position for all of the creditor banks. Interbank politics have been one of the more important factors influencing the course of rescheduling negotiations, yet one of the less well understood. One reason for interbank discord, beyond the normal commercial rivalries of this intensely competitive business, has been the fear that debt relief advanced by one creditor might simply be used to pay off someone else, thus leaving the debtor's financial position unchanged. Once a debt-servicing problem develops, creditor banks naturally want to reduce their exposure in the debtor country. They may be willing to go along with efforts to float new loans or reschedule old ones to allow the country more time to work out its problems, but only as part of a joint effort of all the country's creditors. And they are decidedly unwilling to increase their own exposures only to reduce that of someone else. Thus the doctrine of "fair treatment" has emerged as the guiding principle of debt-restructuring negotiations: each bank is expected to participate in debt relief (either new funding or rescheduling) in proportion to its existing exposure. The enforcement of that doctrine, however, is no easy matter. Short-term trade financing is generally not covered, and often banks have sought to reduce their exposure by allowing such credits to expire, thus exacerbating the debtor's foreign exchange shortage and debt-servicing difficulties.

Also contributing to interbank tension have been differences of opinion over the terms that should be offered to the debtor country, with some banks favoring a hardline approach while others adopt a more generous posture, in the belief that the debtor should be given more room to maneuver. In some cases, such divisions follow national lines, with U.S. banks favoring one position and German or French banks another, for example. At other times, however, banks divide up on the basis of size, with large banks adopting one posture and small banks another. Negotiating postures are often influenced by expectations of future business with the debtor country, with banks that hope to do a lot of business taking a more conciliatory attitude than those that do not. Negotiating positions are also influenced by the size of each bank's exposure, reflecting the old adage that a large enough debt turns a creditor into a partner. Further, bank negotiating positions are sometimes determined by the personnel that each chooses to send to the bargaining table with country lending officers — whose basic orientation is toward selling future loans — tending to take a softer line than, say, credit review officers.

A final source of interbank tension is the danger that one or more banks will break rank and strike a separate deal or will attempt to have the debtor nation declared in default and its external assets attached. Because of the cross-default clauses included in most loan syndications, even one such default declaration could set off a chain reaction of defaults, leading to a massive legal tie-up that could take years to unravel. Still, the probability of such a disaster should not be overestimated. Declaring default would only make sense if the initiating bank held deposits from the debtor country sufficient to cover its outstanding loans, but the deposits and other foreign assets of countries in debt service difficulty are generally only a small fraction of their total obligations. In addition, such a bank would be considered a pariah by its peers and could find its access to other international business reduced.

Country advisers. When Indonesia's state-owned oil company Pertamina ran into financial difficulty in 1975, the Indonesian central bank called in three investment banks to assist the troubled company work out its debts with its foreign creditors. The three — Kuhn Loeb of New York, S.G. Warburg of London, and Lazard Freres of Paris — later formed a consortium to provide financial advisory services to other developing countries; their clients have included Zaire, Turkey, Gabon, and Sri Lanka. Similarly, Morgan Grenfell has advised Sudan and Oman.[3]

In past reschedulings, these firms have assisted their clients by pulling together the data on how much they owed and to whom, by advising them on the terms they might reasonably expect from the banks and, in some cases, by actually negotiating on their behalf. But though such services have greased the wheels of the rescheduling process, the investment bankers' role has drawn a good deal of fire from the commercial bankers' side of the table. While applauding the investment firms' assistance in reorganizing and consolidating their clients' debt service accounts (which, in some cases, were in shocking states of disarray) and in toning down the debtors' more unrealistic demands, some commercial bankers fear that, by interposing themselves between debtor and creditor, the investment advisers will inhibit the development of the confidence and trust necessary in such situations. In addition, these bankers believe that the investment firms will attempt to duplicate the terms won for one country for all of their other clients, with the result that rescheduling will become less flexible, more concerned with precedent, more legalistic and more adversarial. Naturally, the investment bankers dispute these contentions, arguing that the debtor countries have every right to expert financial counsel, just as they have to top-flight legal advice.

Relationship to Official Rescheduling

In four of the six cases covered in the IMF study, the debtor nation also negotiated a multilateral rescheduling of official debt under the auspices of the Paris Club. In these cases, creditor governments insisted on the principle of "comparable treatment" of other creditors. Like the banks, they did not want to grant debt relief only to see it used to bail out someone else — particularly when the "someone else" was a private commercial bank that had extended credit presumably in full awareness of the risks of nonpayment. Nonetheless, a comparison of the terms of the private and official reschedulings reveals that the official creditors were somewhat more generous. This primarily reflects the fact that private loans carry variable interest charges at market levels, while rates on official loans are fixed and below-market. However, official creditors were also more willing to reschedule interest in arrears and resume lending once the agreement had been signed. The banks, by contrast, reflecting their quite different motivations for lending, were understandably more reluctant to return to "business as usual" until the debtor's creditworthiness markedly improved.

Role of the IMF

In each of these six cases, the staff of the International Monetary Fund provided technical support to the negotations. The IMF provided the banks with information on the debtor nations' economic outlook and payment prospects; this was done in an informal manner, either by telephone or in meetings between bank officials and Fund personnel. The IMF also aided the countries involved in preparing for their negotiations with the banks, particularly in those cases where the lack of reliable statistical data was an important problem. In four of the cases, IMF staff members sat in on discussions between the banks and the countries, and on one occasion, when talks were at an impasse, the IMF played a more active role by trying to mediate the dispute.

In each instance, the banks suggested that the debtor country negotiate an upper credit tranche program with the IMF. Such programs were important to the banks not so much for the hard currency provided but as signs that the countries had embarked on the road to recovery. In five out of the six cases, such a program was in place at the time the rescheduling agreement was signed, with the disbursement of new funds or the consolidation of existing obligations being made contingent upon the country's compliance with the terms of its IMF arrangement.

The flow of information between the IMF and the banks has not been strictly one-way, however, since the IMF needs to know the magnitude of expected private capital flows, including debt relief, in devising a realistic adjustment program for countries with payments problems. In some cases, the IMF has even offered its suggestions to the banks on what would be an appropriate amount of debt relief, in one case playing an "active role" (the words are from the IMF staff study) in assuring that the banks in fact provided the targeted level of assistance.

The reschedulings of Peru's and Nicaragua's debts illustrate both the importance and limits of the IMF's role. In 1976, before Peru had begun talks with the IMF, the banks agreed to a $400 million balance of payments support loan conditional upon the government's compliance with its announced stabilization program. That program had been drawn up at the request of the banks and strongly resembled standard IMF orthodoxy, although the IMF was not involved in either its design or its execution. The banks soon found, however, that they were unable to monitor the program in the manner of the IMF; they had neither the expertise nor the standing to do so. Peru's performance quickly diverged from that promised by the program, and the banks were forced to cancel the second $200 million installment of the loan. At that point, the IMF was called in.

The lack of IMF participation in the Nicaragua talks reflected the unusual political circumstances surrounding those negotiations, which help, in part, to explain the unusually favorable terms that resulted. The IMF had begun talks with the Somoza government on a stabilization program in 1978; the two sides reached agreement, in fact, only a few weeks before that regime fell in 1979. After their accession to power, the Sandinistas renounced the agreement and would have nothing further to do with the Fund, despite the devastated state of the Nicaraguan economy and its need for foreign exchange. Nicaragua was able to succeed in shutting out the IMF, however, only because of the donations, soft loans, and central bank deposits it received from other governments and multilateral institutions — the World Bank and Inter-American Development Bank in particular. With its foreign exchange coffers replenished, Nicaragua was able to avoid the need for an IMF agreement and was in a stronger bargaining position with the banks. The moral and financial support it received, however, was coupled with pressure to reach a rescheduling agreement. In this way, the "good offices" role normally performed by the IMF was filled instead by its sister institutions.

The absence of the IMF from the Polish rescheduling underscores the need for a process flexible enough to handle situations involving non-IMF members. Unfortunately, the institutions that stepped into the breach in Nicaragua were unable to do the same in Poland, and no other intermediaries have yet appeared.

Alternatives to the Present Process

Those who are concerned over the adequacy of the present system (or lack thereof) often express their preference for a more formalized, institutionalized process, perhaps under IMF auspicies. The Fund is probably the most logical institutional home for such a mechanism, in light of its pivotal role in balance of payment adjustment cases. However, if a commercial bank rescheduling mechanism were to be set up under the IMF umbrella, several important obstacles would have to be overcome. Not the least of these are the somewhat skeptical attitudes toward the IMF of both parties to rescheduling negotiations. Debtor countries may view the Fund as a collection agent for the commercial banks, while many bankers, for their part, believe that the Fund is ultimately answerable to its member governments and is thus biased toward the interests of the debtor. In any event, private creditors will probably be wary of surrendering any of their legal claims to a supranational arbitration body, however (and wherever) institutionalized.

Another possible institution that could aid in rescheduling negotiations is the suggested International Banking Consultative Group (described on pp. 33 through 35).

Whatever procedures for rescheduling are ultimately decided upon, or simply evolve, it may be useful to anticipate them at the time loans are originally extended by incorporating the appropriate clauses in the loan documentation. Such language would have the advantage of specifying in advance the conditions under which rescheduling would be appropriate and how the talks should be conducted, thereby reducing the costly delays usually associated with getting the negotiations underway. The other side of such specificity, however, is the loss of the flexibility of the current process. In addition, such clauses would of course not be binding upon the parties to other loan syndications not including them; they might, therefore, be rendered inoperative if these other creditors did not agree to them.

Conclusion

Procedural reforms will not, of course, avert the difficult financial problems which lead to reschedulings. But the prospect of such problems underscores the importance of procedures intended to avoid their less desirable effects. The likelihood of continued large payments deficits and the possibility of debt service problems in major debtor countries suggest that rescheduling will be a recurring feature of the international financial system of the 1980s. If so, participants in that system may wish to alter the process of rescheduling so as to improve its probability of success, either by the proposals offered here or by some other, as yet unsuggested, reforms. Reforms of the rescheduling process should thus be a matter for active consideration.

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[1] Occasionally, these governments met in the Hague or London; sometimes they styled themselves as OECD or IBRD consortia. Despite the variance in place and name, however, their basic structure and function was analogous to that of the Paris Club.

[2] Bahram Nowzad, Richard C. Williams, et al., "External Indebtedness of Developing Countries," Occasional Paper No. 3, International Monetary Fund, Washington, D.C., May 1981. This note draws heavily on information contained in the IMF study and two other recent papers (A Porzecanski, "The Assessment of Country Risk: Lessons from the Latin American Experience," in Garcia-Zamor and Sutin, eds., *Financing Development in Latin America* (NY: Praeger, 1980); and L. Brainard and T. Trebat, "The Role of Commercial Banks in Balance of Payment Crisis — The Cases of Peru and Poland," presented to the International Conference on Multinational Corporations in Latin America and Eastern Europe, March, 1981) as well as the case studies of Nicaragua and Turkey presented to the Study Group and recent material from the press and trade journals.

[3] See Anthony Sampson, *The Money Lenders* (New York: Viking Press, 1982), pp. 218—220.

APPENDIX C

Trends in Eurocurrency Credit Participation 1972-1980

Diane Page and Walter D. Rogers

The burgeoning Eurocurrency credit market exceeded $70 billion in publicized volume in 1980, compared to $9 billion in 1972. Today, the bulk of publicized Eurocurrency lending is done by bank syndicates rather than individual institutions. Although the financial press annually allocates syndicated Euroloan volume among managing institutions, identifying the world's top Eurolenders, no one has documented the steady influx of new loan participants into the Eurocurrency credit market or comprehensively considered the changing nationality of participants over time. Using World Bank data, Office of the Comptroller of the Currency staff were able to examine these non-volume indicators of the increasing breadth of the publicized Eurocurrency credit market.[1]

Analysis of the World Bank data shows that a relatively constant average of 66 independent financial institutions became first-time entrants into the Eurocurrency credit market each year between 1973 and 1980. By 1980, nearly 400 independent financial institutions were active in the market. In the earlier years, the new entrants were largely European and North American banks and international consortium banks. More recently, Latin American, Middle Eastern and Asian institutions have entered the market in greater numbers. Further findings from the World Bank data reinforce the well-documented expansion of Middle Eastern financial institutions into Eurocurrency lending. For example, in terms of number of participating institutions, Middle Eastern institutions have increased their presence in the market from less than one percent in 1972 to an eight percent share of the total in 1980. However, in every year, European and U.S. institutions ac-

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count for the bulk of total participating institutions as well as total loan participations.

Introduction

Analysis in this paper is restricted to publicized Eurocurrency credits. It examines financial institutions which were Eurocurrency loan participants between 1972 and 1980, considering their nationality, entry into the Eurocurrency market, and number of yearly loan participations.

Eurocurrency credits are loans and credit lines denominated in a currency other than that of the country in which the lending institution is located. Eurocurrency credits first appeared in the 1960s. At that time, they were almost exclusively fixed-rate loans to corporate borrowers underwritten by specialized investment banks, notably the British merchant banks, which later sold participations to other banks. The Eurocurrency credit market began to take on its present characteristics in the early 1970s. Loans became floating rate instruments. Nations began to finance balance of trade deficits through Eurocurrency borrowings. And the world's large international commercial banks began managing large Eurocurrency credits through syndications. Syndication of credits reduced risk for the underwriters and brought together the large resources necessary to finance sovereign debt. With successive oil price increases in 1973 and 1974, the oil-producing nations developed trade surpluses while non-oil-producing less-developed countries faced growing deficits. The Eurocurrency credit market began to serve a vital function as a recycling mechanism, moving surplus capital from the oil-producers to the non oil-producing nations. Publicized Eurocurrency credits reached a volume of $70.4 billion in 1980, according to World Bank data. Publicized credits, which are medium- to long-term and usually syndicated, represent only a portion of international borrowing. It has been estimated that one-half of Eurocurrency bank lending is short term, unpublicized lending used for private trade and international business financing.[2] International and foreign bond issues are another vehicle for international borrowing, and accounted for $41.8 billion in 1980.[3]

Description of the Data

Data collected by the World Bank cover publicized borrowing in international capital markets in the form of Eurocurrency credits between 1972 and 1981.[4] Notice of Eurocurrency credits appears in a published announcement known as a tombstone. The tombstone generally contains the name of the borrower, the amount of the credit, and the names of the financial institutions which participate in the loan. Often, but not always, Eurocurrency credits are led by a single large institution. Smaller volume credits are less likely to have a lead manager, while some loans have two or more co-lead managers. The lead manager receives a mandate from the prospective borrower to raise funds and seeks to put together a managing group.

The lead manager typically underwrites the entire amount of the credit, making a commitment to provide the funds before arranging the syndication. On the tombstone, institutions are usually listed in order of the size of the participation they take in the loan. As a rule, the lead manager is listed first, followed by managers, co-managers, and participants, which take successively smaller portions of the loan. When institutions are listed in alphabetical order, this generally indicates that each participant has taken an equal participation. Sometimes institutions are listed in alphabetical order within manager, co-manager and participant sub-groups.

Table I

Eurocurrency Credit Aggregates 1972-1980

Year	Loan Volume ($ billions)	Total # Loans	Total # Participations	% Loans with Unnamed Participants	% Participations By Unnamed Participants
1972	8.8	258	415	1	1
1973	20.8	402	725	1	1
1974	28.5	474	1027	1	1
1975	20.6	418	1482	5	6
1976	28.7	430	1827	8	9
1977	34.2	489	2360	10	10
1978	73.7	786	3781	15	20
1979	70.2	813	4329	16	22
1980	70.4	797	4913	18	24

Source: World Bank data.

* A small percentage of participants are listed as "syndicates" and thus actually represent more than one institution.

Computerized World Bank data identify by name a maximum of ten participants per individual Eurocurrency credit in order of their appearance on the tombstone. When a loan has more than ten participants, nine participants are identified by name and the number of additional, unnamed participants is indicated. Since these additional participants are not identified, there is no way to ascertain how many individual institutions participated in all loans in each year. However, it is possible to aggregate the total number of named and unnamed *participations* for all loans in each year, and likewise to determine how many loans had unnamed (more than ten) participants. As shown in Table I, an increasingly significant proportion of total loan participations, 24 percent by 1980, have been taken over time by participants not identified by name in the World Bank data. The number of loans with unnamed participants increases to 18 percent of total loans by 1980. The reader should bear in mind that, in most of the following discussions of participant nationality, new entry and loan participations, only named participants, those who took the first nine or ten listed positions on each loan, are considered. It was not possible to identify the unnamed participants or to draw any conclusions about their entry trends or nationality patterns.

In the following analysis, information has been provided on those institutions appearing as first listed participant for each loan in the World Bank data, i.e., institutions listed first on the loan tombstones. Although this information provides some indication of the nationality distribution of lead managers, it should be interpreted with caution. As explained above, lead managers usually appear first on the publicized loan notices. However, since some credits have no lead manager, some credits have a number of co-lead managers, and some tombstones list all participants alphabetically, first participant position in the World Bank data is not a perfect proxy for lead manager. (World Bank staff estimate that about 20 percent of the Eurocurrency credit tombstones list participants alphabetically.)

Nationality of the named participants is not included in World Bank data and was determined using a variety of almanacs, yearbooks and other reference sources. Institutions were grouped by nationality of ownership rather than country of charter; Euroloan activity of branch offices or subsidiary companies has been credited to the head office or parent institution. For example, Deutsche Bank AG, Deutsche Bank AG (London), and Deutsche Bank Cie. Fin. Luxembourg were all considered part of a single German financial institution when determining the number of German Euroloan participants, German entry into the market, and the number of German loan participations.

Results

Between 1972 and 1980, the number of publicized Eurocurrency credits tripled from 258 to 797 and their combined volume increased from $8.8 to $70.4 billion, according to World Bank data (see Table I).[5] The following analysis is based on a direct comparison between Eurocurrency credit activity in 1972 and 1980, since changes between 1972 and 1980 reflect trends which characterize the intervening years. However, the figures are also affected by specific factors such as the slowdown in U.S. Eurolending dating from 1979 and government restrictions on foreign lending of Japanese banks in 1980. (See Appendix tables.)

Number of lenders

The number of named loan *participants*, consolidated into parent institutions, nearly tripled from 133 to 386 between 1972 and 1980. Figure I shows a geographic breakdown of these institutions in 1972 and 1980.[6] (Consortium banks were placed in the Asian, European and Middle Eastern categories when their owning institutions were identified as all Asian, all European or all Middle Eastern.) The absolute number of managers in all geographic categories increased, but relative shares of the total changed over time. The predominance of European institutions, well over one third of the total in both years, is evident, as is the growing importance of the Middle Eastern institutions, which represented less than one percent of the total share in 1972 and 8 percent in 1980. The share of U.S. and Canadian institutions, on the other hand, dropped by ten percent of the total, while the share of Asian institutions dropped by five percent of the total.

New entry

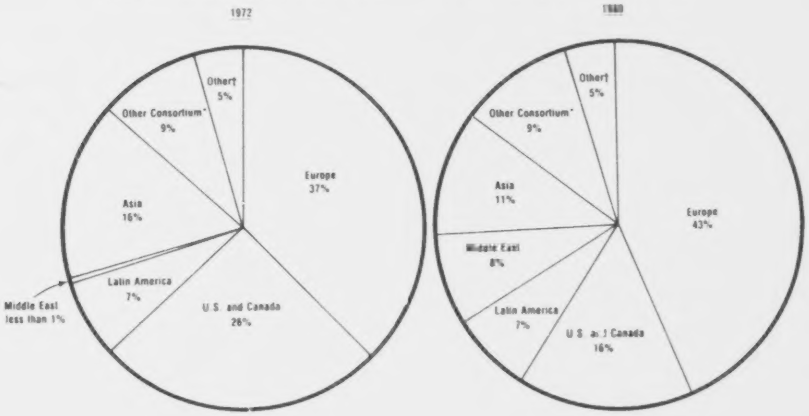
Between 1973 and 1980, 526 parent institutions which had not participated in any previous year for which data are available entered the Eurocurrency credit market. The number of new entrants is relatively constant, averaging 66 per year (Figure II).

Figure I

Nationality of Parent Financial Institutions Participating in the Publicized Eurocurrency Credit Market

1972 & 1980

(First through Tenth Listed Participants Only)



Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

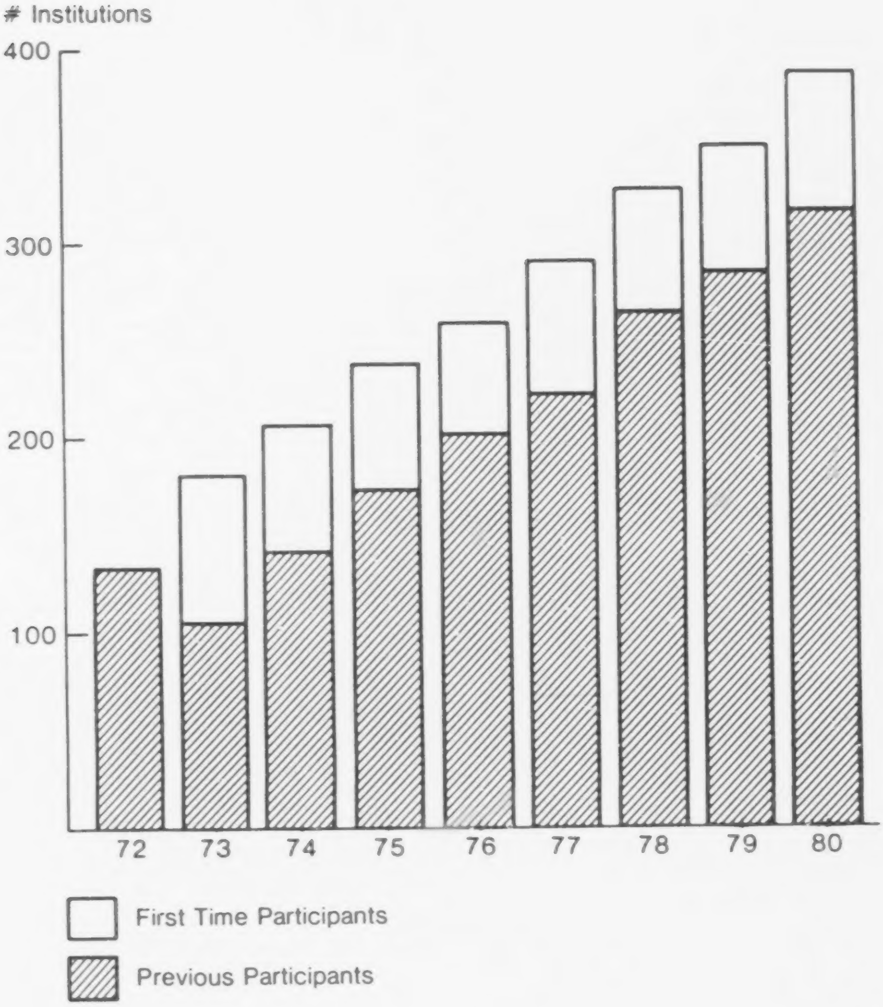
† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

Financial Institutions
Participating in the Euroloan Market
1972-1980
(First through Tenth Listed Participants Only)

	72	73	74	75	76	77	78	79	80
Austria	0	0	4	4	4	11	5	7	14
Belgium	4	3	3	5	4	3	3	4	4
Luxembourg	3	3	3	4	5	7	11	7	7
Fed. Rep. of Germany	5	7	10	13	13	17	17	22	21
France	9	15	14	16	15	17	17	22	19
Italy	3	5	6	5	8	9	18	12	15
Netherlands	0	1	3	4	5	5	5	6	5
Spain/Portugal	2	5	9	13	14	13	11	19	22
Switzerland	2	2	4	4	9	9	8	9	11
United Kingdom	18	24	20	18	19	18	18	19	18
Other, W. Europe	1	9	9	18	12	14	14	16	17
E. Europe	1	2	3	3	2	1	1	2	5
Total	48	76	88	107	110	124	128	145	158
Canada	3	4	7	9	7	9	9	10	9
USA	31	40	41	46	46	43	49	50	54
Total	34	44	48	55	53	52	58	60	63
Mexico/Central/S. Amer.	6	3	5	6	5	8	8	12	23
Caribbean	3	2	5	3	4	3	2	4	3
Middle East	1	2	3	6	11	17	25	23	25
Africa	1	0	1	1	1	2	1	2	3
Japan	17	21	17	7	13	18	24	24	24
Other Asia	5	2	4	5	4	9	11	16	19
Total	22	23	21	12	17	27	35	40	43
Oceania	2	0	1	2	1	1	3	5	8
Consortia	12	22	30	36	48	49	60	51	51
of which European	1	4	4	5	6	7	7	8	9
Arab	0	0	1	2	3	5	9	6	6
Asian	0	1	1	1	1	0	0	1	0
Other	11	17	24	28	38	37	44	36	36
Unidentified	4	6	5	7	6	5	7	5	9
GRAND TOTAL	133	178	207	235	256	288	327	347	386

Figure II

First-Time and Previous Participants in the Publicized Eurocurrency Credit Market*
1972-1980



* Refers to first-time entry since 1972; data not available for previous years.

Financial Institutions Entering the Euroloan Market for the First Time*

1973-1980

(First through Tenth Listed Participants Only)

	73	74	75	76	77	78	79	80
Austria	0	4	1	1	5	1	0	5
Belgium	0	0	1	1	0	0	1	0
Luxembourg	0	0	2	3	3	3	0	2
Fed. Rep. of Germany	2	5	4	1	4	1	4	2
France	7	2	4	2	3	0	6	1
Italy	2	1	1	2	5	5	2	1
Netherlands	1	2	1	2	2	1	0	0
Spain/Portugal	3	4	5	2	1	1	6	7
Switzerland	1	2	0	5	3	1	3	2
United Kingdom	9	2	1	1	0	1	0	1
Other, W. Europe	8	3	9	3	1	0	0	1
E. Europe	1	1	1	0	0	0	0	3
Total	34	26	30	23	27	14	22	25
Canada	1	3	3	1	1	0	1	0
USA	13	9	10	7	5	7	6	10
Total	14	12	13	8	6	7	7	10
Mexico/Central/S. Amer.	2	2	0	0	3	3	3	10
Caribbean	0	2	0	0	2	0	3	1
Middle East	2	3	2	6	9	11	7	3
Africa	0	0	0	1	1	0	2	1
Japan	4	1	0	1	2	4	1	1
Other Asia	2	1	2	1	6	4	5	10
Total	6	2	2	2	8	8	6	11
Oceania	0	0	1	0	0	1	4	2
Consortia	13	14	13	14	7	15	6	5
of which European	3	0	1	2	1	0	1	0
Arab	0	1	2	1	1	4	0	1
Asian	1	1	1	0	0	0	0	0
Other	9	12	9	11	5	11	5	4
Unidentified	4	4	3	2	3	4	4	5
GRAND TOTAL	75	65	64	56	66	63	64	73

* Refers to first-time entry since 1972; data for previous years not available.

Table II

Nationality of Parent Financial Institutions Entering the Publicized Eurocurrency Credit Market for the First Time*

1973-1980

		Nationality				Other	
Year	Eur.	N. Amer.	Latin Amer.	Asian	M. East	Consortium	Other
1973	37	14	2	2	7	9	4
1974	26	12	4	4	3	12	4
1975	31	13	0	4	3	9	4
1976	25	8	0	7	2	11	3
1977	28	6	5	10	8	5	4
1978	14	7	3	15	8	11	5
1979	23	7	6	7	6	5	10
1980	25	10	11	4	11	4	8
TOTAL	209	77	31	53	48	66	42

Source: World Bank data

* Refers to first-time entry since 1972; data not available for previous years.

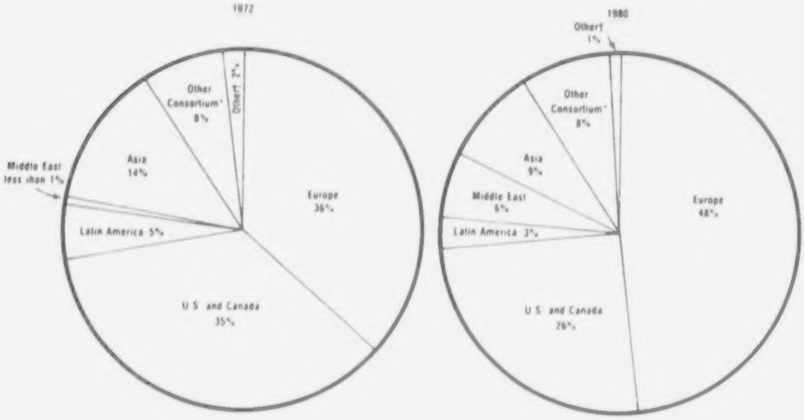
Table II shows the nationalities of the new entrants. European, North American and Other Consortium institutions (consortium banks whose owners did not fit nearty into a regional category) demonstrate a declining rate of new entry. This is not surprising since institutions from countries with the most internationally active and highly developed banking systems entered the Eurocurrency credit market first. Also, consortium banks were established early as a means of access to the market. Latin American, Asian and Middle Eastern institutions exhibit increasing rates of new entry over time. (Asian rates would be more pronounced if not for the effect of periodic Japanese government restrictions on foreign lending, which caused Japanese entry and participation in the syndicated Euroloan market to fluctuate. Other Asian nations demonstrate steadily increasing participation.) While European institutions continue to dominate the new entry table in terms of sheer numbers, the increasing entry of institutions from other regions indicates the growing breadth of the Eurocurrency credit market.

Number of Loan participations

Total yearly loan *participations* by all institutions provide a measure of Eurocurrency credit market size distinct from dollar volume measures. The number of participations by both named and unnamed participants grew from 415 to 4,913 between 1972 and 1980, a twelvefold increase. Participations by named participants, which grew from 412 to 3,723 in that time period, are categorized by nationality in Figure III. In terms of loan participations, European institutions increased their share from just over one third to almost half the yearly total. Again Middle Eastern growth is notable, from a less than one percent to a six percent share. Both the North American and Asian shares declined, by ten percent and five percent of the total respectively.

Figure III

Publicized Eurocurrency Credit Market Participations
by Nationality of Participant
1972 & 1980
(First through Tenth Listed Participations Only)



Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

First listed participants

World Bank's first listed participants can be used as a proxy, albeit an imperfect one, for Eurocurrency credit lead managers. It is evident that changes in national shares of total first listed participants are consistent with other share changes described in previous sections. Figure IV illustrates that European institutions account for almost half of total first participants positions in 1972 and 1980. North American institutions moved from holding first participant position in almost a third of all Eurocurrency credits to a 22 percent share in the same time period. Asian institutions maintained a stable first participant share of approximately ten percent, while Middle Eastern institutions, which appeared in *no* first participant positions in 1972, had a seven percent share in 1980.

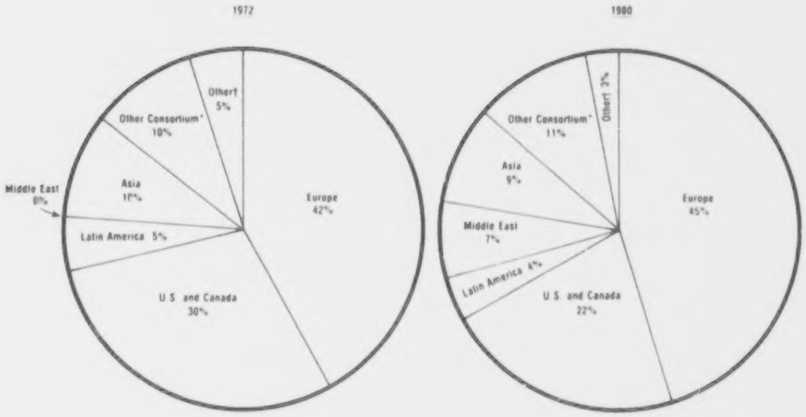
Euroloan Participations by Nationality of Participant
1972-1980
(First through Tenth Listed Participants Only)

	72	73	74	75	76	77	78	79	80
Austria	0	0	5	16	7	42	15	31	41
Belgium	12	6	17	28	12	35	49	106	110
Luxembourg	8	9	15	11	27	31	51	70	45
Fed. Rep. of Germany	11	15	59	115	108	219	254	300	254
France	27	67	125	100	92	103	162	223	395
Italy	9	25	22	7	11	15	39	55	98
Netherlands	0	2	8	27	28	45	81	78	67
Spain/Portugal	5	7	29	32	36	41	38	77	100
Switzerland	2	4	9	20	32	47	63	74	76
United Kingdom	65	106	113	127	156	207	280	357	416
Other, W. Europe	2	15	16	35	48	47	46	71	81
E. Europe	3	4	7	11	6	1	2	6	17
Total	144	260	425	529	563	833	1080	1448	1700
Canada	10	24	44	117	121	153	261	284	301
USA	136	239	346	503	653	658	749	613	657
Total	146	263	390	620	774	811	1010	897	958
Mexico/Central/S. Amer.	10	3	8	29	19	22	29	60	95
Caribbean	9	10	12	3	5	3	2	4	9
Middle East	1	5	4	19	19	48	106	80	113
Africa	1	0	1	1	3	2	2	2	5
Japan	51	99	37	14	32	97	355	466	258
Other Asia	6	4	7	14	11	24	36	42	80
Total	57	103	44	28	43	121	391	508	338
Oceania	2	0	2	3	1	1	5	5	25
Consortia	36	70	128	161	233	284	373	386	467
of which European	4	9	25	14	19	37	45	55	72
Arab	0	0	1	4	8	12	50	54	92
Asian	0	1	1	1	1	0	0	2	0
Other	32	60	101	142	205	235	278	275	303
Unidentified	6	6	9	15	9	6	9	9	13
GRAND TOTAL	412	720	1023	1408	1669	2131	3007	3399	3723

Figure IV

Total Publicized Eurocurrency Credits by Nationality of First-Listed Participants

1972 & 1980



Total = 230** Total = 798**

Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

** Totals do not match loan totals in Table I due to omissions in World Bank data.

Number of Euroloans by Nationality of First-Listed Participant[1]
1972-1980

	72	73	74	75	76	77	78	79	80
Austria	0	0	3	3	1	3	3	2	6
Belgium	6	2	3	7	1	7	7	13	19
Luxembourg	4	4	3	3	7	10	7	14	8
Fed. Rep. of Germany	4	7	20	19	23	39	67	55	40
France	19	34	58	32	23	19	35	45	70
Italy	2	7	7	1	2	4	15	8	9
Netherlands	0	1	2	6	8	6	17	8	12
Spain	1	1	2	5	6	10	8	21	27
Switzerland	1	1	4	4	2	1	10	21	22
United Kingdom	45	83	73	50	46	50	73	100	90
Other, W. Europe	0	2	3	7	11	18	18	19	19
E. Europe	3	0	0	3	0	0	0	0	0
Total	85	142	178	140	130	167	260	306	322
Canada	6	12	7	14	10	14	35	55	45
USA	87	145	179	181	190	194	286	242	231
Total	93	157	186	195	200	208	321	297	276
Mexico/Central/S. Amer.	1	0	3	6	4	2	12	11	15
Caribbean	7	10	6	1	2	2	1	1	1
Middle East	0	3	3	1	2	6	34	17	28
Africa	0	0	0	0	0	0	1	0	0
Japan	11	33	12	2	5	12	45	66	24
Other Asia	1	2	3	8	5	4	4	2	11
Total	12	35	15	10	10	16	49	68	35
Oceania	1	0	1	1	0	0	2	2	5
Consortia	26	31	59	51	79	84	96	105	114
of which European	1	1	3	3	8	11	11	15	21
Arab	0	0	1	2	4	1	16	10	14
Asian	0	0	0	1	1	0	0	0	0
Other	25	30	55	45	66	72	69	80	79
Unidentified	5	1	4	5	0	4	0	3	2
GRAND TOTAL[2]	230	379	455	410	427	489	776	810	798

[1] First-listed participant in World Bank data usually refers to the lead manager.

[2] Totals do not equal Eurocurrency loan totals found in Table I in the text due to omissions in World Bank data.

Conclusion

World Bank data, although identifying only ten participants per Euroloan, can be used to provide some information on the pace of new entry into the Eurocurrency credit market and patterns of changing nationality among lending institutions. Conclusions drawn from the data become less certain in later years, because of the significant increase in the number of unidentified participants listed beyond position ten in individual loans.

The picture resulting from a study of the data is one of a growing and broadening syndicated Eurocurrency credit market between 1972 and 1980. The growth in number and volume of loans has been accompanied by a growth in the number of institutions participating in those loans. Growth in total number of loan participations has outstripped the growth rate in number of loans; this is another indicator of increased market breadth. A steady average of 66 new institutions has entered the market yearly.

Institutions headquartered in Europe and North America, active in the Euroloan market in earlier years by virtue of their well developed international banking presence, still accounted for the bulk of yearly participations, lending institutions and first listed participants (a proxy for lead manager) in 1980. However, new lender institutions from these countries are entering the publicized Eurocurrency credit market at a declining rate. In recent years, increasing numbers of new entrants are from Latin America, Asia and the Middle East. Institutions from the Middle East as a whole have increased their share of yearly loan participations, loan leadership and representation among lending institutions notably, from less than one percent of the total in 1972 to six to eight percent in 1980. This increased share has been balanced in part by the declining share of North American institutions.

Endnotes

[1] World Bank data are limited, identifying a maximum of ten participant institutions per individual loan. This limitation becomes more important over time. See Table I for the number of loans with unidentified (greater than ten) participants on a yearly basis.

[2] Laurie Goodman, "The Pricing of Syndicated Eurocurrency Credits," Federal Reserve Bank of New York *Quarterly Bulletin*, Summer 1980, p 40.

[3] Morgan Guaranty Trust Company, *World Financial Markets*.

[4] The World Bank stopped collecting this type of data as of the second quarter of 1981, since it is now available from several other sources such as Caploan and the Euromoney syndication service.

[5] Volume of publicized Eurocurrency credits is available from many other sources including Morgan Guaranty Trust Company, the OECD and Caploan. Reported numbers differ due to differences in timing, coverage, etc. Compare, for example, the World Bank figures with those found in Morgan Guaranty's *World Financial Markets*: $6.9 billion in 1972 and $76.8 billion in 1980.

[6] Tables from which these charts are derived may be found in the following these notes.

APPENDIX D

Overview of National Regulatory Arrangements

Richard Dale

National authorities use a variety of approaches and controls to foster bank safety and soundness and to maintain confidence in the banking system as a whole. The techniques employed may be broadly categorized into preventive regulation designed to limit risks incurred by banks; schemes which offer protection to depositors in the event of bank failure; and support provided by national monetary authorities to banks experiencing liquidity difficulties (the lender of last resort function).

Preventive Regulation

Among measures aimed at controlling the levels of risk incurred by banks are those concerned with market entry, capital and liquidity adequacy, permissible business activities, foreign currency exposure, concentration of loans and country risk exposure.

In virtually all national banking systems regulation begins at the market entry stage. Before they can be authorized, banks must satisfy various requirements which typically include a reputable management and some minimum amount of subscribed capital, the capital requirement, where formalized, varying from the equivalent of US$1m (Switzerland) to nearly US$10m (United Kingdom). For both competitive and prudential reasons branches of foreign banks must generally possess a specified amount of endowment capital, although the United Kingdom imposes no such requirement while Canada limits all foreign-owned banks to the subsidiary form. Several countries apply an economic need criterion and in such cases market entry may be restricted or (as in Italy) suspended altogether with a view to curbing excessive and destabilizing competition.

In addition to a minimum capital requirement, banks are generally

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Richard Dale is currently a Rockefeller Foundation International Relations Fellow based at the Brookings Institution.

required to maintain an appropriate relationship between capital on the one hand and total assets, risk assets or liabilities on the other. However, some countries (Italy, Canada) do not formally regulate capital adequacy, others (including the United States) make an essentially judgmental assessment while most European countries apply solvency ratios of varying complexity which incorporate different weightings for different categories of risk asset. In this last case, the weightings applied to similar categories of asset may vary. For instance, whereas Switzerland applies a premium weighting to all foreign assets, the Netherlands accords a preferential zero weighting to loans to foreign governments. In addition, one country (Belgium) applies a solvency ratio which discriminates in favor of larger banks on the grounds that small banks are more risky.

Definitions of capital differ, particularly in the treatment of subordinated debt. A few countries such as West Germany exclude subordinated debt altogether, others include it up to a limit that varies between 10 per cent and 50 per cent of total capital, while the United States federal supervisory agencies have not agreed on a common approach to this question. Because of the variety of methods used in capital adequacy assessment, it is not possible to make direct comparisons between requirements in different countries.

Capital adequacy may or may not be assessed on a world-wide consolidated basis and branches of foreign banks may or may not be separately assessed. However, the general trend is towards consolidation as indicated by recent moves in this direction by Switzerland and Germany. Even so, the treatment for consolidation purposes of non-wholly owned subsidiaries and minority interests may differ.

As with capital adequacy, approaches to the measurement and control of liquidity vary considerably. Some countries (including the United States and Canada) choose not to lay down formal prudential liquidity requirements while others (notably the Netherlands, Germany and Switzerland) apply a number of ratios designed to limit the extent of maturity mismatching in banks' balance sheets. In a few cases (for instance France and Italy) banks which accept short-term deposits are regulated separately from those engaging in longer term banking business, and special limits may be placed on their term lending. Where regulation is formalized, distinctions may or may not be drawn on the assets side between primary, secondary and other classes of liquidity and on the liabilities side between interest-sensitive money market funds and retail deposits. In addition, the treatment of foreign currency items varies, with France, for instance, requiring separate calculations for local and foreign currency liquidity. Although most national schemes seek to classify liabilities both by maturity and volatility, with a view to determining the extent to which funds may prudently be used as a basis for maturity transformation, direct comparisons of permissible transformation are not possible because of the variety of assessment methods and other institutional differences.

In general, liquidity regulation does not take account of undue deposit concentrations, although the Netherlands imposes extra liquidity requirements on "large item" liabilities. Some countries (notably the United States) assess liquidity on a world-wide consolidated basis, others (such as France) confine their regular assessments to banks' domestic offices, while branches of foreign banks may or may not be included in the assessment process.

Typically, banks are limited as to the kinds of business they can engage in although such restrictions may in part reflect non-prudential concerns such as potential conflicts of interest or undue concentrations of economic power. There is no generally accepted distinction between banking and non-banking business and restrictions in this area not only differ in scope but are also imposed in a number of different ways. Several countries (notably the United States, Canada and France) prohibit the mixing of banking and non-banking business within the bank entity while permitting participation in at least some kinds of non-banking activity through bank holding companies, subsidiaries and/or minority interests. Other countries (such as the Netherlands) permit the bank entity itself to engage directly in non-banking business but limit the scope for investment in non-bank companies. A third approach (illustrated by France) permits a wider range of activities to be undertaken by a special category of separately regulated universal banks. Finally, some countries (such as the United Kingdom, Switzerland and Germany) impose few restrictions on the kinds of business banks may engage in, whether directly or through affiliates. In the case of international operations, restrictions may be relaxed so as to enable foreign branches of domestic banks to compete more equally in their country of residence with local banks.

In the area of foreign exchange risk, all countries monitor banks' exposure and seek to ensure adequate internal control procedures, but there are marked differences in regulatory procedures. Some countries (including the United States, Canada and France) prefer to avoid general limits or norms, others (such as the Netherlands and Switzerland) apply incremental capital requirements to uncovered positions, while a third group (including Germany and the United Kingdom) imposes guidelines or formal limits on aggregate, and in some cases, individual foreign currency positions. Where limits are indicated, they are generally stated as a percentage of bank capital. The monitoring and control of foreign currency exposure may (as in the United States) embrace foreign branches and subsidiaries of domestic banks, but in other cases, foreign subsidiaries are excluded while the treatment of local branches of foreign banks also varies.

Most supervisory authorities seek to limit risk concentrations by imposing formal or informal limits on each banks' loans to a single borrower. Stated as a percentage of the lending bank's capital, the limits vary between 100 per cent (Italy) and 10 per cent (the United States), subject to varying definitions of capital for this purpose. In general these lending ceilings are not directly applicable to country risk exposure involving several borrowing entities from the same country, although the US statutory 10 per cent limit may be applied in this way where there is a common source of repayment.

On the other hand, most countries do attempt to measure and monitor their banks' country risk exposure. Sometimes (as in the United States and United Kingdom) this is done on the basis of world-wide consolidated data, embracing cross-border and non-local currency loans to foreign borrowers adjusted for third party guarantees. In other cases (for instance Italy, France and Germany) exposure data is not fully consolidated while risk transfers via third party guarantees are generally ignored. Several countries (notably Germany, Switzerland and Belgium) require banks to report their methods of country risk evaluation, while the United States categorizes countries into three risk classes in order to assess the extent of banks exposure to potential defaults. Such exceptions apart, regulators do not generally seek to form an independent judgment as to individual countries' financial prospects. Nor do regulators impose an absolute limit on total country risk exposure, although Switzerland applies a special premium capital requirement to banks' foreign assets.

The role of bank inspections in the regulatory process varies considerably from country to country. At one end of the spectrum is the United States where regular on-site examinations lie at the heart of the supervisory system and whose examiners are required to provide a composite rating of each bank on a standardized basis. At the other end of the spectrum is the United Kingdom which eschews bank inspections in favor of a surveillance system based on interviews with management backed by extensive reported data. Routine on-site bank examinations, where they occur, may be conducted by the supervisory authorities' own inspectorate (as in the United States, Canada, Italy and France), special auditors appointed and paid for by the authorities (Belgium), auditors licensed by the authorities and subject to special statutory duties (Switzerland) or general auditors (Germany). Examinations may take place annually (as in Canada), every 3-4 years (Italy) or at intervals varying between 1 to 2 and 10 years depending on the size and standing of the institution concerned (France). Several countries confine on-site examinations to banks' head offices while few (a major exception being the United States) conduct routine inspections of banks' foreign establishments.

Deposit Insurance

Most countries either have or are in the process of introducing deposit protection schemes. Such schemes may be official (as in the United States, Canada and United Kingdom) but frequently they are organized by the banking industry itself with the encouragement of the authorities (as in France, Germany and the Netherlands). Countries which do not have any formal deposit protection arrangements include Italy and Luxembourg.

Typically, the protection offered is territorial in scope, thereby embracing branches and subsidiaries of foreign banks and excluding deposits with foreign offices of domestic banks. However, there are exceptions: the German scheme covers foreign branches of German banks and the Belgian scheme excludes local branches of foreign banks. Foreign currency deposits may or may not be protected, there are variations in the eligibility of both deposits (for instance certificates of deposit) and depositors (most but not all schemes exclude inter-bank deposits) and the size limits imposed on protected deposits vary from the equivalent of under US$20,000 (Canada, United Kingdom) to $100,000 (United States). In addition the United Kingdom and Swiss schemes (as proposed) require that the depositor bear some proportion of any loss. Some schemes provide for a deposit protection fund while others are unfunded but in either case banks are typically subject to a flat-rate contribution based on the total of their deposits (France being an exception in providing for a scale of graduated contributions which discriminates in favor of larger banks).

Lender of Last Resort/Emergency Measures

Generally, national monetary authorities are prepared to provide financial assistance to commercial banks experiencing temporary liquidity difficulties, although in some centers (for instance Luxembourg and Hong Kong) there is no indigenous central bank to perform this function. A distinction can usually be drawn between routine use of the official discount window, where the conditions of access are often formalized, and emergency support operations undertaken on a discretionary basis. In general, emergency assistance is provided directly by the central bank but in some countries (Belgium and Germany) it is channelled through a special fund jointly established by the authorities and the commercial banks. Frequently, such assistance can be offered only to solvent institutions and on a secured basis but some authorities have broader powers of intervention where insolvency is threatened. In other cases (as in the United States and Canada) the deposit insurance agency may have lender of last resort powers which, at least in respect of potentially insolvent institutions, may exceed those of the central bank. Finally, whereas emergency assistance is typically extended directly to troubled banks at a penal interest rate, this is not necessarily the case: for instance, the Bank of Italy's practice is to lend at below market rates to institutions prepared to acquire/assist the problem bank (a technique also employed by the US deposit insurance agency).

As a matter of policy, the precise scope of the lender of last resort function, in the emergency assistance sense, is not publicly stated. However, national authorities generally look to foreign parent institutions for the support of their local subsidiaries and for this purpose some countries (notably the United Kingdom and Canada) require non-legally binding undertakings or 'letters of comfort' from the parent acknowledging responsibility to support its subsidiary beyond the limits of strict legal liability. On the other hand, in the United States subsidiaries as well as branches of foreign banks have a formalized right of access to the central bank's discount window, at least for the purpose of routine liquidity assistance.

Among other emergency measures that may be available are the regulation of interest rates to ease pressures on financial markets (as provided for in France and the Netherlands), assisted mergers, the appointment of caretaker managers to troubled banks and special liquidiation proceedings. In this last case, local branches of foreign banks may, in the event of the parent institution's failure, be subject to separate liquidation proceedings in which case (as under New York State and Dutch law) branch creditors sometimes enjoy a preferential claim to branch assets.

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Author's Note

Dr. Richard Dale, a barrister and economist, is currently a Visiting Scholar at the Brookings Institution and a Rockefeller Foundation International Relations Fellow. Formerly, he was an executive with merchant bankers N.M. Rothschild and Sons, Ltd., in London.

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Bank Supervision Around the World

Richard Dale

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Bank Supervision Around the World

Preface

The present study reflects concerns arising out of the recent rapid expansion of international lending and the growing tendency for banks to service their international business from offices established outside their home country. The emergence of global banking networks straddling numerous national jurisdictions poses special problems for supervisory authorities. Firstly, international lending may involve risks additional to and distinct from those experienced in domestic banking operations. Secondly, unless national regulatory responsibilities are carefully co-ordinated there is a danger that some kinds of banking activity may escape supervision. Thirdly, uneven regulatory practices can lead to a situation in which banks are drawn to the most permissive regimes. And, more generally, the increasing interdependence of banks and banking systems points to the need for a global approach to the problems of bank safety and soundness.

This study does not address the complex policy issues associated with the growth of multinational banking. Rather, it provides a descriptive overview of prudential regulation in the major financial center countries in the hope that this may help to identify those areas in which there is scope for further international co-ordination.

The study is divided into four sections comprising (1) summary and findings; (2) a brief description of international supervisory co-operation; (3) a comparative survey of national regulatory arrangements and (4) a survey of regulatory practices in each of the Group of Ten countries (other than Sweden), Switzerland, Hong Kong and Singapore.

This study is part of the ongoing work of the International Banking Study Group.

Summary and Findings

Every national financial system has distinctive institutional characteristics which have a direct bearing on the authorities' approach to bank regulation. Some countries have a highly concentrated banking industry favoring an informal regulatory regime based on direct contact with management, while others have a fragmented structure calling for more formal methods of control. Similarly, where supervisory responsibility is vested in a ministry of finance or central bank it is likely to be exercised with a wider degree of discretion than in those countries where a banking commission, operating within defined statutory limits, is the primary supervisory agency. In some countries regulatory arrangements may vary, depending on whether a bank has a national or regional base or whether it is federally or state chartered. Finally, the concept and definition of a 'bank' varies from country to country and deposit-taking institutions may, for regulatory purposes, be differentiated according to whether or not they enjoy full banking status.

Despite these and other institutional differences between countries, certain common trends in regulatory practice have emerged in recent years, due in part to growing international co-operation in this area. In the first place there has been a tendency towards a more formal regulatory framework even in those countries which have traditionally preferred a non-statutory approach to bank supervision. Secondly, several countries have in recent years extended their regulatory coverage to non-bank deposit-taking institutions. Thirdly, most countries now endorse the principle of parental responsibility in the sense that they delegate a major share of supervisory responsibility to the home country authorities of foreign branches to whom they are host, while exercising some degree of supervisory control over the foreign establishments of banks headquartered within their jurisdiction. In a related development, most national authorities are beginning to use consolidated data when applying solvency and other prudential criteria to locally incorporated banks with foreign branches and subsidiaries.

While recognizing such signs of gradual convergence in national regulatory arrangements, the present study also highlights a number of areas where regulatory disparities and gaps persist. It is suggested that the following potential sources of weakness in the international regulatory regime need to be addressed:

1. Some financial centers have endorsed the principle of parental responsibility to the point where they are relying heavily on home country authorities for the supervision of foreign banks to whom

they are host. On the other hand not all home country authorities are prepared to accept the degree of responsibility placed upon them in this way. The result is that certain banks may, for some purposes at least, be largely unsupervised.

2. A closely related cause for concern is that the principle of consolidated supervision which was accepted by the Group of Ten Governors in 1978 has been implemented only selectively. For instance, official monitoring of foreign exchange and country risk exposure frequently overlooks the activities of banks' foreign subsidiaries.

3. In many instances, neither host nor home country authorities monitor or regulate liquidity in the Euro-currency markets. This is also an area where the Basle Concordat's guidelines are unclear.

4. Although most countries are beginning to assess capital requirements on a consolidated basis there is no common approach to the definition of capital and still less to the question of what constitutes capital adequacy.

5. To the extent that restrictions on permissible business activities reflect prudential considerations, it is a matter for concern that banks can in some cases escape these limitations when operating in foreign markets.

6. In the key area of country risk exposure, most national authorities are still feeling their way towards appropriate methods of identifying, measuring and controlling risks. In the absence of established supervisory procedures banks are typically free to establish their own exposure limits for country risk.

7. The role of on-site bank examinations varies from country to country but in several jurisdictions foreign regulatory authorities are not permitted to inspect banks for which they retain supervisory responsibility. In such jurisdictions, too, the host authorities may be prevented by bank secrecy laws from communicating information about locally based banks to foreign supervisors. Under these circumstances the principle of parental responsibility cannot be fully implemented.

8. Not all countries have deposit insurance schemes and those that do offer widely differing coverage with respect to the size, type, cur-

rency denomination and situs of deposits. In order to avert the danger that perceived differences in national protective arrangements could provoke destabilizing capital movements in times of uncertainty, greater co-ordination in this area is desirable.

9. For similar reasons, it is a matter for concern that lender of last resort facilities differ considerably from country to country. A few financial centers have no lender of last resort capacity. Some national authorities can provide only temporary liquidity assistance on a secured basis, while others are able and willing to sustain even insolvent institutions in order to protect depositors. These disparities apart, there is a danger that some authorities may be prevented from extending collateralized assistance to banks' foreign branches where national laws confer on branch depositors preferential claims to branch assets.

These findings are broadly consistent with a recent Group of Thirty survey* of bankers' attitudes towards the international financial market. From this it is clear that banks themselves perceive sharp differences in national regulatory arrangements, although their concerns in this area tend, understandably, to be more of a competitive than a prudential nature. It is significant that North American banks, in particular, believe they suffer a competitive disadvantage as a result of extensive domestic regulation, notably with respect to loan size requirements and restrictions on permissible activities as well as capital requirements. It is also significant that a large majority of both North American and European banks surveyed would like to see greater harmonization of regulatory requirements.

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* "How Banks See the World Financial Market", Group of Thirty, May, 1982.

I. International Supervisory Cooperation

The techniques of supervision lagged the internationalization of banking through the early 1970s. As Peter Cooke of the Bank of England has put it, "neither the supervisors, nor indeed the banks themselves had fully appreciated the degree to which the banking environment was changing in character and the new increased risks involved in international business. Supervisors were still very much domestically oriented within the framework of different national banking systems."

The financial disturbances of 1974 focused attention on the need for greater international co-operation in the field of bank supervision. In September 1974, the central bank governors issued a statement of assurance that temporary support for banks in need of liquidity was available. They also created a standing committee of bank supervisors, under the auspices of the Bank for International Settlements, comprising the Group of Ten countries plus Switzerland. This Committee on Bank Regulations and Supervisory Practices (now called the "Cooke Committee," after its chairman) meets three times a year, its members working cooperatively to coordinate surveillance over the international banking system and sharing ideas about adapting their various national supervisory systems to deal effectively with the changing banking environment.

One of the earliest and most far-reaching initiatives of the Cooke Committee was to develop broad guidelines for the division of responsibilities between national supervisory authorities. These guidelines, which were approved by the Central Bank Governors of the Group of Ten in December 1975, are known as the "Basle Concordat" and have been described by Peter Cooke as "a most important cornerstone of international supervisory co-operation". The following key principles are embodied in the Concordat:

1. The supervision of foreign banking establishments is the joint responsibility of parent and host authorities;
2. No foreign banking establishment should escape supervision;
3. The supervision of liquidity should be the primary responsibility of the host authorities;
4. The supervision of solvency is essentially a matter for the parent authority in the case of foreign branches and primarily the responsibility of the host authority in the case of foreign subsidiaries;
5. Practical co-operation should be promoted by the exchange of information between host and parent authorities and by the authorization of bank inspections by or on behalf of parent authorities on the territory of the host authority.

Another important initiative of the Cooke Committee has been to recommend to the Governors that the supervision of banks' international business should be conducted on a consolidated basis. The reasoning here is that consolidated supervision enables parent supervisors to view each banking group's risk exposure and capital adequacy on a global basis while making it impossible for a bank to evade regulation applied to the parent by transferring business to foreign establishments. The consolidation principle was endorsed by the Group of Ten Governors in 1978 and is now being implemented.

The Cooke Committee has taken steps to disseminate information about its work more widely around the world with a view to establishing a broader basis for supervisory co-operation. The Committee has for instance, initiated a series of discussions with a recently constituted group of supervisors from offshore centers for which Hong Kong is currently co-ordinator. The two international conferences for bank supervisors, held in London in 1979 and Washington in 1981, have also provided an opportunity for an exchange of views on the Committee's work among bank supervisors from all over the world.

While much of the work on international supervisory co-operation has taken place under the aegis of the Bank for International Settlements and the Cooke Committee, other bodies have been playing a role in this area. The Committee on Financial Markets of the Organization for Economic Co-operation and Development affords the opportunity for central bankers, finance ministry officials, bank supervisors, and banks to meet and discuss common concerns. This Committee has also set up an Expert Group on Banking to assist in the preparation of a series of studies covering among other subjects, the scope of prudential supervision in major industrial countries.

Within the European Community harmonization of banking supervision is viewed as one element in the creation of a common market in banking as envisaged in the Treaty of Rome. The First Banking Coordination Directive adopted in 1977 provides for minimum authorization criteria, the calculation of common prudential ratios (which in the first instance are for observation purposes only) and the establishment of an Advisory Banking Committee to assist the EEC Commission in its co-ordination work. As a follow-up to the 1977 Directive the EEC Commission has recently drafted proposals for the standardization of banks' annual accounts, the supervision of banks on a consolidated basis and the co-ordination of winding up procedures. At the same time the Advisory Banking Committee has introduced a series of observation ratios covering solvency, liquidity and profitability which are currently being applied on a trial basis.

The Advisory Banking Committee is a high-level policy-making committee consisting of not more than three representatives from each member state and from the EEC Commission. It meets usually twice a year in Brussels and is backed by a secretariat provided by the EEC Commission. The Committee works alongside the Commission and lays down general policy guidelines relating to supervisory co-ordination within the European Community.

The EEC Commission and the Advisory Banking Group are supported in their co-ordination work by an informal club of member state supervisory authorities known as the Contact Group. This Group was established in 1971 in order to provide national supervisors with a forum for the free exchange of views and an opportunity to develop an understanding of each others' regulatory systems. The Group continues to fulfil these functions but in addition, undertakes detailed technical studies which may, after transmission to the Advisory Banking Group or the EEC Commission, provide a basis for formal harmonization proposals. The Contact Group also frequently submits its papers to the Cooke Committee with which it maintains a close working relationship.

II. Overview of National Regulatory Arrangements

National authorities use a variety of approaches and controls to foster bank safety and soundness, and to maintain confidence in the banking system as a whole. The techniques employed may be broadly categorized into preventive regulation designed to limit risks incurred by banks; schemes which offer protection to depositors in the event of bank failure; and support provided by national monetary authorities to banks experiencing liquidity difficulties (the lender of last resort function).

A. Preventive Regulation

Among measures aimed at controlling the levels of risk incurred by banks are those concerned with market entry, capital and liquidity adequacy, permissible business activities, foreign currency exposure, concentration of loans and country risk exposure.

1. Market Entry

In virtually all national banking systems regulation begins at the market entry stage. Before they can be authorized banks must satisfy various requirements which typically include a reputable management and some minimum amount of subscribed capital, the capital requirement, where formalized, varying from the equivalent of US$200,000 (Netherlands) to nearly US$10million (UK). For both competitive and prudential reasons branches of foreign banks must generally possess a specified amount of endowment capital, although the UK imposes no such requirement, while Hong Kong has introduced a minimum assets criterion for foreign banks seeking to establish local branches. Several countries apply an economic need criterion and in such cases market entry may be restricted or (as in Italy and Hong Kong) suspended from time to time with a view to curbing excessive and destabilizing competition. In financial centers such as Singapore, where domestic and offshore banking operations are separated, entry controls may allow a greater degree of competition in the offshore market than is permitted domestically.

Entry of foreign-owned banks may be formally limited to subsidiaries (as in Canada) on the grounds that locally incorporated entities can be more effectively regulated by the host authority. In contrast, some other countries (Japan, Hong Kong, Singapore) have preferred to confine full banking status to branches rather than subsidiaries of foreign banks, because a branch is considered to enjoy the full support of the group to which it belongs.

It is also the practice of a number of countries (Canada, the UK, Hong Kong and Singapore) to request letters of comfort from foreign banks wishing to establish local financial subsidiaries. Although not generally considered to be legally binding, these letters are in some instances being requested in a form which the banks concerned believe to have the force of law. A few countries (Hong Kong, Singapore) adjust their prudential requirements according to whether or not a letter of comfort has been obtained, while others (France, Belgium) are prepared to waive certain solvency or liquidity requirements where a specific guarantee has been received from the foreign parent bank. German subsidiaries of foreign banks may have to provide binding letters of indemnification from their parent institutions in respect of any payments that may be made by the German Deposit Protection Fund to the subsidiary's depositors. While Italy appears to be unique in requiring Italian branches of foreign banks to produce a formal declaration from their head office stating that, under its own law, the head office is liable to the full-extent of its assets for the liabilities of its foreign branch.

2. *Capital Adequacy*

In addition to a minimum capital requirement, banks are generally required to maintain an appropriate relationship between capital on the one hand and total assets, risk assets or liabilities on the other. However, some countries (Hong Kong, Italy, Japan, Canada) do not formally regulate capital adequacy, others (including the United States) make an essentially judgmental assessment while most European countries apply solvency ratios of varying complexity which incorporate different weightings for different categories of risk asset. In this last case, the weightings applied to similar categories of asset may vary. For instance, whereas Switzerland applies a premium weighting to all foreign assets, the Netherlands at present accords a preferential zero weighting to loans to foreign banks and governments (though the position here may change shortly). In addition, one country (Belgium) applies a solvency ratio which discriminates in favor of larger banks on the grounds that small banks are more risky. The United Kingdom calculates both a gearing and a risk assets ratio but does not apply a general norm to all or any class of banks.

Definitions of capital differ, particularly in the treatment of subordinated debt. A few countries such as Germany exclude subordinated debt altogether, others include it up to a limit that varies between 10 per cent and 50 per cent of total capital while the US federal supervisory agencies have a divided approach to this question. Because of the variety of methods used in capital adequacy assessment, it is not possible to make direct comparisons between requirements in different countries. Nevertheless, where capital adequacy guidelines are or can be expressed in terms of a gearing ratio (whose precise definition may vary) this can range between: 50x for a foreign-owned merchant bank in Singapore with a letter of comfort from its parent, 33x for Luxembourg banks, 30x for the larger Canadian domestic banks, 20x for a foreign-owned Canadian bank and 15x for a foreign-owned consortium bank in Singapore. The maximum gearing guideline for non-multinational US domestic banks supervised by the Comptroller of the Currency or the Federal Reserve is 14x to 20x depending on the category of bank and the definition of capital used. US multinational banks are not at present subject to a norm but they are expected to reduce their gearing over a period of time towards the levels permissible for non-multinational US banks.

Where, on the other hand, capital adequacy is assessed against risk assets rather than total assets the indicated norm ranges between 10% (Netherlands) and 5% (France, Belgium). It should, however be stressed that exemptions, special risk categories and different definitions of capital make direct comparisons hazardous.

Capital adequacy may or may not be assessed on a world-wide consolidated basis, although the general trend is towards consolidation as indicated by recent moves in this direction by Switzerland, Germany and Belgium. Even so, the treatment for consolidation purposes of non-wholly owned subsidiaries and minority interests may differ. In general, host countries monitor and regulate the capital adequacy of foreign banks' local subsidiaries. Some host countries also treat branches of foreign banks as separate entities for capital adequacy purposes, although this may reflect competitive rather than prudential concerns.

3. Liquidity Control

As with capital adequacy, approaches to the measurement and control of liquidity vary considerably. Some countries (including the United

States and Canada) choose not to lay down formal prudential liquidity requirements while others (notably the Netherlands, Germany and Switzerland) apply a number of ratios designed to limit the extent of maturity mismatching in banks' balance sheets. In a few cases (for instance France and Italy) banks which accept short-term deposits are regulated separately from those engaging in longer term banking business and special limits may be placed on their term lending. Where regulation is formalized, distinctions may or may not be drawn on the assets side between primary, secondary and other classes of liquidity and on the liabilities side between interest-sensitive money market funds and retail deposits. Although most national schemes seek to classify liabilities both by maturity and volatility with a view to determining the extent to which funds may prudently be used as a basis for maturity transformation, direct comparisons of permissible transformation are not possible because of the variety of assessment methods and other institutional differences. In general, liquidity regulation does not take account of undue deposit concentrations, although the Netherlands imposes extra liquidity requirements on "large item" liabilities and the United Kingdom requires deposit concentrations of 5% or more to be reported quarterly.

It is generally recognized that the management of foreign currency liquidity may present special problems in so far as banks lack direct access to the lender of last resort in that currency. On the other hand, there is no common approach to the treatment of foreign currency items for liquidity purposes. Some financial centers such as Singapore specifically exempt banks' foreign currency operations from the liquidity requirements that apply to local currency business. Others such as Hong Kong apply liquidity norms uniformly to local and foreign currency items. Japan pays particular attention to Japanese banks' Euro-currency activities which are subject to a special mismatch limit. France requires separate calculations for local and foreign currency liquidity while Germany applies limits to foreign exchange exposure which serve the additional purpose of limiting maturity mis-matching in foreign currencies. More typically, however, foreign currency business is not subject to liquidity rules or guidelines.

Some countries (notably the United States) assess liquidity on a world-wide consolidated basis, some (such as Japan) include foreign branches but not subsidiaries in the assessment process, while others (for instance France) confine their regular assessments to banks' domestic offices. Branches of foreign banks may or may not be assessed for liquidity by the host authority.

4. Permissible Business Activities

Typically, banks are limited as to the kinds of business they can engage in, although such restrictions may in part reflect non-prudential concerns such as potential conflicts of interest or undue concentrations of economic power. There is no generally accepted view as to what is and what is not legitimate banking business. Some countries (notably the United States, Canada and Japan) formally separate commercial from investment banking and prohibit commercial banks from underwriting equities. Restrictions are more often imposed on banks' investments in property and also on equity holdings in non-bank companies. In the latter case limits may be expressed both as a percentage of the lending bank's capital, the ceiling here varying between 100% (France) and 25% (Hong Kong), and/or as a percentage of the non-bank company's equity, with the maximum holding ranging from 2% (Italy) to 20% (France).

Several countries prohibit the mixing of banking and non-banking business within the bank entity while permitting participation in at least some kinds of non-banking activity through bank holding companies, subsidiaries and/or minority interests. Other countries (such as the Netherlands) permit the bank entity itself to engage directly in non-banking business but limit the scope for investment in non-bank companies. A third approach (illustrated by France) permits a wider range of activities to be undertaken by a special category of separately regulated universal banks. Finally, some countries (such as the United Kingdom, Switzerland and Germany) impose few formal restrictions on the kinds of business banks may engage in, whether directly or through affiliates, although these countries typically impose heavy risk weightings on certain kinds of business activity for the purpose of calculating solvency requirements.

In the case of international operations, restrictions may be relaxed so as to enable foreign offices of domestic banks to compete more equally in their country of residence with local banks. Alternatively, where the home authority imposes no authorization requirements or other controls on banks' foreign establishments, the host jurisdiction alone determines the extent of permissible activities.

5. Loan Concentration and Country Risk

Most supervisory authorities seek to limit risk concentrations by imposing formal or informal limits on each banks' loans to a single borrower. Stated as a percentage of the lending bank's capital, the limits vary between 100% (Italy) and 10% (the United States), subject to varying definitions of capital for this purpose. These limits may or may not be applied on a consolidated basis and branches of foreign banks may or may not be separately assessed (several countries, for instance, look to group rather than branch capital in this context).

In general, lending limits to individual borrowers are not applied to country risk exposure involving several borrowing entities from the same country. The United States is, however, an exception in that its 10% statutory lending limit has been interpreted to apply collectively to loans to foreign governments, their agencies and instrumentalities unless a) the borrower has an independent source of repayment and b) the loan is to be used for the borrower's business. The United States approach to country risk is also distinctive in that federal regulators categorize countries into three risk classes for the purpose of determining prudent lending limits for each country beyond which a bank's loans may be 'listed' or subject to comment. Few other authorities claim to take an independent view of individual countries' financial prospects, although the United Kingdom does make such an assessment. More generally, supervision of country risk is influenced by the fact that regulators are often reluctant to be seen to challenge the judgement of commercial bankers in an area which can also give rise to political difficulties.

On the other hand, most countries do attempt to measure and monitor their banks' country risk exposure. Sometimes (as in the United States and United Kingdom) this is done on the basis of world-wide consolidated data, embracing cross-border and non-local currency loans to foreign borrowers adjusted for third party guarantees. In other cases (for instance Italy, France, Germany, and Japan) exposure data is not fully consolidated while risk transfers via third party guarantees are generally ignored. Some countries (for instance Hong Kong) which collect consolidated country exposure data largely for BIS purposes do not use it as a basis for prudential supervision. The consolidation issue apart, there is some uncertainty about the appropriate measurement of country risk, as when a commercial borrower has an independent source of hard currency repayment outside the jurisdiction of the country in which it is based. Furthermore, there is concern that even local currency lending to foreign borrowers may give rise to country risk.

Several countries (notably Germany, Switzerland and Belgium) require banks to report their methods of country risk evaluation. On the other hand, not all authorities to whom such reports are made have developed a procedure for assessing the adequacy or otherwise of such evaluation techniques. There appears to be a division here, too, between those regulators who feel they have a duty to screen banks' country risk evaluation methods and those who wish merely to alert banks to the need for country risk assessment.

While country risk is now among the foremost supervisory concerns, regulators have not attempted to impose an absolute limit on total country risk exposure but instead focus on the need for diversification. Switzerland comes nearest to an aggregative approach in applying a special premium capital requirement to banks' foreign assets. In contrast, some other countries apply a preferentially low capital requirement to loans to foreign governments.

6. *Foreign Currency Exposure*

In the area of foreign exchange risk, most countries monitor banks' exposure and seek to ensure adequate internal control procedures, but there are marked differences in regulatory procedures. Some countries (including the United States, Canada and France) prefer to avoid general limits or norms, others (such as the Netherlands and Switzerland) apply incremental capital requirements to uncovered positions, while a third group (including the United Kingdom and Germany) imposes guidelines or formal limits on aggregate, and in some cases, individual foreign currency positions. Singapore has recently discontinued regular prudential returns relating to foreign currency exposure, relying instead on spot checks during the bank examination process.

Where exposure limits are indicated, they are generally stated as a percentage of capital, although Japan places limits on each bank based in part on the volume of foreign exchange transactions. The United Kingdom has an exposure guideline for all currencies together equal to 15% of capital. Since this is expressed as an aggregate net short position (rather than a combined net long and short position) it is equivalent for most purposes to Germany's 30% of capital limit which relates to the difference between a bank's foreign currency assets and liabilities. However, because the UK guideline embraces sterling whereas Germany's excludes Deutschemark items, German banks have twice the latitude of UK banks when taking long or short positions in their local currency.

Few countries (the United States being an exception) monitor or regulate foreign currency exposure on a consolidated basis. Most countries exclude foreign subsidiaries, some exclude foreign branches and the treatment of local branches of foreign banks also varies.

7. *Bank Inspection*

The role of bank inspections in the regulatory process varies considerably from country to country. At one end of the spectrum is the United States where regular on-site examinations lie at the heart of the supervisory system and whose examiners are required to provide a composite rating of each bank on a standardized basis. At the other end of the spectrum is the United Kingdom which eschews bank inspections in favor of a surveillance system based on interviews with management backed by extensive reported data. Routine on-site bank examinations, where they occur, may be conducted by the supervisory authorities' own inspectorate (as in the United States, Canada, Italy, France and Japan), special auditors appointed and paid for by the authorities (Belgium), auditors licensed by the authorities and subject to special statutory duties (Switzerland) or general auditors (Germany). Examinations may take place annually (as in Canada), every 3-4 years (Italy) or at intervals varying between 1 to 2 and 10 years depending on the size and standing of the institution concerned (France). Several countries confine on-site examinations to banks' head offices while others (such as Japan) make a random selection of branches for inspection purposes.

The principle of parental responsibility dictates that home country supervisors should have access to information about banks' foreign establishments. Few countries, however, conduct examinations of foreign branches or subsidiaries, although the United States aims to do so routinely (the Comptroller of the Currency has a permanent office in London for this purpose) while Japan and Germany also carry out periodic examinations of foreign branches. On the other hand, several countries, notably Luxembourg, Singapore and Switzerland, do not allow access to foreign inspectors and in these cases, too, bank secrecy laws limit the flow of information both between host and home authorities and between foreign-owned banks and their parent institutions. Furthermore, France, which previously allowed access to US inspectors, is no longer able to do so because of new legislation protecting commercial information. In the context of current EEC initiatives in this area it is evident, too, that some countries are reluctant to establish a formal right of access to foreign inspectors.

B. Deposit Insurance

Most countries either have or are in the process of introducing deposit protection schemes. These may be official (as in Canada, the United Kingdom and the United States), organized by the banking industry itself with the encouragement of the authorities (as in France, Germany and the Netherlands) or jointly administered by the authorities and the banks (as in Belgium and Japan). In general, participation is mandatory although not every bank is a member of the German scheme and foreign banks having equivalent coverage from home-based schemes may be exempted. Countries which do not have any formal deposit protection arrangements include Hong Kong, Italy, Luxembourg and Singapore.

Typically, the protection offered is territorial in scope, thereby embracing branches and subsidiaries of foreign banks and excluding deposits with foreign offices of domestic banks. However, there are exceptions: the German and Japanese schemes cover foreign branches of domestic banks while the Belgian and Japanese schemes exclude local branches of foreign banks. All schemes cover both residents' and non-residents' deposits but there is an even split between those that protect foreign currency deposits (Belgium, Germany, the Netherlands and the United States) and those which do not (Canada, France, Japan and the UK). Most schemes exclude inter-bank deposits (Canada being an exception) while certain categories of term deposits as well as certificates of deposit may also be excluded.

In all cases there is a maximum amount per depositor per institution beyond which protection is not provided, the rationale here being that large depositors are in a better position to assess bank risk than small depositors. The deposit ceilings range from the equivalent of US$13,000 (Japan) to US$100,000 (United States), although Germany is unusual in imposing a limit equal to 30% of the failed bank's state equity capital while Belgium applies a discretionary deposit cut-off point (an approach that has recently been challenged in the Belgian courts). Also exceptional are the United Kingdom and (proposed) Swiss schemes which require the depositor to bear some proportion of any loss, the purpose and effect here being to provide a limited form of consumer protection rather than to prevent precautionary deposit withdrawals.

The United States is unique in that its deposit protection agency has broad powers which can be used to assist or merge troubled banks and thereby avoid deposit pay-offs. Reflecting the agency's active use of these powers and its long-established aversion to deposit pay-offs, 99.9% of all depositors with failed US banks recovered the full amount of their deposits in the period 1934-1980. To this extent the $100,000 cut-off point for US deposit protection is largely redundant.

Most deposit protection arrangements are insurance schemes proper in the sense that depositors have a legal right to be paid off. However, the German scheme is discretionary and there is some doubt also about the Belgian scheme's status from this point of view. Furthermore, there are wide differences in funding arrangments and in the capacity to make large-scale deposit pay-offs. Some schemes (as in France and the Netherlands) are unfunded and rely wholly or largely on ad hoc levies on participant banks to cover deposit losses as they occur. In the case of funded schemes the size of established funds varies between just over 1% of insured deposits (United States) and 0.035% of insured deposits (Japan), although most funds can be supplemented by official borrowing. Contributions to funded and unfunded schemes are typically flat-rate and calculated on the basis of each bank's total deposits. France, however, provides for a graduated scale of contributions which discriminates in favor of larger banks on the grounds that they are less risky.

C. Lender of Last Resort/Emergency Measures

In general, national monetary authorities are prepared to provide financial assistance to commercial banks experiencing temporary liquidity difficulties. A distinction can, however, usually be drawn between routine use of the official discount window, where conditions of access are often formalized, and longer-term support operations undertaken on a discretionary basis.

Although emergency assistance is typically extended directly by the central bank at a penal interest rate, there are alternative methods of support. In Belgium and Germany, for instance, funds are channelled through a special facility jointly established by the authorities and the commercial banks. The Bank of Italy's practice is to lend at below market rates to institutions prepared to acquire/assist the problem bank — an approach also employed on occasion by the US deposit insurance agency. More generally, support may be provided, with or without official encouragement, by one or more large domestic banks: the Hong Kong and Shanghai Bank has fulfilled this function in Hong Kong, as has the Bank of Tokyo in Japan (in respect of foreign currency liquidity), and the UK clearing banks were involved in large-scale emergency assistance during the UK secondary banking crisis of 1973-75.

Some financial centers, notably Luxembourg, Hong Kong and Singapore, have no indigenous central banks in the conventional sense. In Luxembourg there is no lender of last resort capacity, in Hong Kong the Government's Exchange Fund is available for this purpose while the Monetary Authority of Singapore has a statutory power to provide liquidity assistance.

Frequently, emergency support can be offered only on a secured basis to solvent institutions, although solvency in this context may not be easily determined. Some countries (for instance, Belgium and the United Kingdom) have broader powers of intervention where insolvency is threatened, while in other cases (as in Canada and the United States) the deposit insurance agency has lender of last resort powers which, at least in respect of potentially insolvent institutions, may exceed those of the central bank. Some central banks are disposed to act as the lender of last resort in domestic currency only, although such funds may in principle be converted if the recipient bank's need is for foreign currency liquidity. Elsewhere the capacity to provide foreign currency assistance is limited by the size of official reserves relative to the volume of locally placed foreign currency deposits.

As a matter of policy, and in order to discourage excessive risk-taking by banks, the precise scope of the lender of last resort function is not publicly stated. This calculated reticence applies both to the circumstances in which assistance may be given and to the allocation of support responsibilities between different national authorities. In several countries (for instance, Japan and the United States) foreign banks have a formalized right of access to the central bank's discount window but it is not clear that this facility would extend to emergency support. In general, national authorities expect foreign parent banks to provide all necessary assistance to their local subsidiaries whether or not letters of comfort have been issued, although the threat of shareholders' actions could in theory place a limit on this commitment. So far as branches are concerned, the US authorities have in the past demonstrated a willingness to provide emergency support to the foreign branch of a US bank, using the head office as a conduit for such assistance.

Among other emergency measures that may be available to avert sudden bank failures are assisted mergers and the appointment of caretaker managers to troubled banks. Furthermore, as indicated above, financial centers frequently look to parent institutions to support foreign-owned banks to whom they are host, for which purpose irrevocable lines of credit and/or letters of comfort may be required or encouraged. Letters of comfort may also serve the purpose of alerting foreign central banks to potential demands for liquidity assistance originating from abroad, particularly where (as for instance in Hong Kong) such letters are required to be issued with the full knowledge of the parent institution's supervisory authority.

Finally, where banks do fail the ensuing liquidation proceedings may be specially designed to protect local depositors. For this purpose several countries treat branches of foreign banks as separate entities requiring their own liquidation and in such cases, too, branch creditors may enjoy a preferential claim to branch assets (as in the Netherlands and Singapore and also under New York State law).

III. Country Surveys

A. Belgium

The Commission Bancaire (CB) is the body responsible for supervising the Belgian banking system. Although the CB has broad statutory powers to lay down prudential regulations it has preferred to adopt a less formal approach. Accordingly, only banks' capital adequacy is governed by formal prudential ratios. The CB also has authority to supervise banks' international operations on a consolidated basis, but is currently seeking to achieve this result on the basis of gentleman's agreements. The CB's functions are confined largely to preventive regulation/supervision, emergency assistance and deposit protection being the province of a separately constituted public body, the Institut de Réescompte et de Garantie (IRG).

1. Entry Controls

Banks are required to register with the CB before they can undertake operations. Registration is only effected when the CB is satisfied that the following criteria for authorization have been satisfied: (1) appropriate legal form (a bank must be a société commerciale, thereby excluding one-man firms); (2) a minimum capital of 50 million francs; and (3) a reputable and competent management. Branches of foreign banks are subject to the same authorization requirements, the branches' capital endowment being for this purpose defined as capital funds permanently allocated to the branch for its activities in Belgium.

2. Capital Adequacy

The solvency regulation stipulates that a bank's holdings of fixed assets should not exceed its capital and reserves. The regulation also applies a capital/risk assets test which (for prudential reasons) favors larger against smaller banks while requiring higher capital cover both for risky assets and for high concentrations of risk exposure to individual borrowers.

The capital/risk assets test involves three steps. Firstly, a bank's total risk quotient is calculated by aggregating the specified solvency requirements applicable to different categories of asset. For this purpose risk-bearing assets are in general subject to a 5% capital requirement with an additional 2.5% demanded where loans to individual borrowers exceed 20% of capital; inter-bank loans attract a lower requirement of 1%; and certain public sector loans (including those to member states of the EEC) are exempt. Secondly, the first and subsequent Fr10 million tranches of the total risk quotient are adjusted upwards by Fr10 million and Fr5 million, respectively, the purpose and effect of this being to impose higher capital ratios on smaller banks. Finally, those assets (notably participations of over 10%) requiring 100% capital backing, having been excluded from the original risk quotient calculation, are added to the adjusted risk quotient to arrive at a bank's total capital requirement.

Capital is defined as the sum of equity capital, reserves (published and hidden), retained earnings and general provisions. In addition, the CB may, at its discretion and subject to certain restrictive conditions, include subordinated debt up to a limit of 50% of total capital. As an exception to the general capital adequacy rules the CB may grant a concession to foreign banks' branches in Belgium and to their subsidiaries enjoying a parent bank guarantee whereby the ratios are applied to their Belgian business alone and not to their international business. The CB is in the process of applying the solvency regulation on a consolidated basis and in February 1982 issued two circulars to this effect.

3. *Liquidity Control*

In contrast to the detailed requirements relating to capital adequacy, liquidity is not formally regulated although the CB has the statutory authority to do so. Liquidity is monitored through the banks' normal statistical returns as well as through auditor's assessments. No precise definition of what constitutes sufficient liquidity has been formulated.

4. *Permissible Business Activities*

The only statutory restrictions on the kinds of business banks can undertake relate to their equity investments. In general banks are prohibited from holding shares in non-bank companies but this so-called law against universal banks has been relaxed in recent years. In particular, banks may now hold shares in connection with their underwriting business while the CB is authorized to allow investments in bank-related businesses such as leasing, factoring and data processing.

5. *Foreign Currency Exposure*

The CB is authorized to issue regulations establishing limits for foreign exchange exposure but has so far declined to do so. The solvency regulation imposes a 0.2% capital requirement on total claims arising from forward foreign exchange transactions but there is no requirement relating to uncovered positions, whether spot or forward. Nevertheless, banks are subject to extensive reporting requirements on their foreign exchange exposure and the CB, through bank auditors, seeks to ensure that each bank's internal controls are fully adequate.

6. Loan Concentrations and Country Risk

Loans to individual customers exceeding 20% of the lending bank's capital are required by the solvency regulation to be backed by additional capital (above). The CB also has statutory authority to formulate and apply loan limits. To date it has not issued regulations in this area but it has as a matter of practice recommended certain banks to reduce their loans to single borrowers in cases where the loans exceeded 50% of the banks' capital.

There are no formal limits on country risk exposure. However, the authorities collect and monitor data on country risk and, since November 1980, have also required bank auditors to report on each bank's approach to country risk evaluation.

7. Bank Examination

Under Belgian law bank auditors play a special role in the supervisory process. They are appointed and paid for by the CB, and their statutory functions go well beyond the verification of the annual accounts: for instance, they must satisfy themselves of each bank's compliance with the regulations and must also monitor the bank's solvency and liquidity position. While reliance is placed on bank auditors for routine supervision purposes the CB maintains its own inspectorate which is used for on-the-spot checks, usually in special circumstances.

8. Deposit Protection and Lender of Last Resort

The Institut de Réescompte et de Garantie (IRG), a public body funded by the commercial banks and jointly administered by them and the Government, offers both deposit protection and emergency liquidity assistance. In its deposit protection role the IRG has a broad discretion (but no obligation) to pay off all creditors of a failed bank, the current practice being to impose a ceiling on the amount payable to each depositor which may vary from case to case. The IRG has not so far redeemed any foreign currency deposits but is empowered to do so. Belgian subsidiaries, but not branches, of foreign banks participate in the scheme.

In its liquidity assistance role the IRG again has wide discretionary powers. In particular support may be given to potentially insolvent institutions while funds advanced need not always be fully secured, the guiding principle being whether intervention is necessary in the public interest. Liquidity assistance may be given to foreign branches, but not subsidiaries, of Belgian banks. Participation in the scheme does not imply a right to intervention either in the bank's favor or in favor of its creditors/depositors.

The IRG's resources are based on the BF1 billion of equity capital subscribed by the commercial banks, money market borrowings, borrowings from the National Bank of Belgium, and a special intervention reserve of BF3 billion also subscribed by the banks. Bank subscriptions are proportionate to their balance sheet totals and their participation in the scheme is subject to renewal every five years.

The National Bank of Belgium continues to provide routine liquidity assistance through its discount window and may also be viewed as the lender of last resort although it has not been called upon to exercise this function since the Second World War.

B. Canada

The Office of the Inspector General of Banks (OIB), as the agency responsible to the Minister of Finance for the administration of the Bank Act, is charged with supervision of the banking system. The OIB must report to the Minister at least once a year on the financial soundness of each bank and advise the Minister on applications for the incorporation of banks.

The OIB's traditional approach to supervision has been characterized by informality, bilateral discussions and an absence of regulations and directives. However, the latest decennial revision of the Bank Act that came into force at the end of 1980, in providing for the chartering of foreign banks, will increase the number of federally supervised banks from 12 to around 70. Accordingly the new Act authorizes the issuance of regulations on capital adequacy and liquidity, as well as directives to individual banks, should the need arise. It remains to be seen whether changed circumstances will oblige the authorities to resort to such formal controls in due course.

The new Bank Act for the first time provides for the chartering of foreign bank subsidiaries, while continuing to prohibit the establishment of branches of foreign banks. Foreign owned banks will, nevertheless, face important constraints on their expansion: individually their domestic assets must not exceed 20 times deemed authorized capital (changes in which can be made at the discretion of the authorities) and collectively their domestic assets must not exceed 8% of the total domestic assets of all banks in Canada.

The revised Act also provides for the incorporation of two classes of banks: Schedule A banks, whose shares are widely held, and Schedule B banks (including foreign bank subsidiaries) whose shares are closely held.

1. Entry Controls

No bank can commence business without the approval of the authorities although only foreign bank subsidiaries are subject to formal licensing requirements. The criteria applied in considering approvals include capital adequacy (generally over and above the statutory minima for authorized capital set out in the Bank Act) and a reputable and experienced management. Foreign banks wishing to establish Canadian subsidiaries must meet additional statutory and non-statutory criteria, notably: (1) the potential to make a contribution to competitive banking in Canada: (2) reciprocity for Canadian banks in the home jurisdiction; (3) a certificate of good standing from the home jurisdiction; (4) a favorable earnings record over the last five years; (5) adequate supervision by the home supervisory authority; and (6) a letter of comfort with regard to the proposed subsidiary.

There are no domestically imposed branching constraints on Canadian banks either at home or abroad.

2. Capital Adequacy

The new Bank Act requires every bank to maintain adequate capital in relation to its operations and to comply with any regulations or directives that may be issued in this connection. In practice, the authorities have continued to avoid formal regulation and rely instead on broad guidelines which focus on banks' leverage ratios (the ratio of total assets to equity capital and reserves). De facto leverage ratios have been rising over a long period and currently vary between 17x and 36x, but guidance has recently been given to the effect that the appropriate maximum ratio for the largest banks is 30x and for the smaller banks 20-25x.

Foreign bank subsidiaries are expected to conform to a maximum leverage ratio of 20x, which is additional to the statutory leverage constraint relating to authorized not actual capital (this having a competitive rather than a prudential function). As from November, 1981 leverage ratios have been calculated on a consolidated basis.

Banks are subject to a statutory prohibition on annual dividend payments which exceed 8% of their paid-in capital unless the general reserve plus retained earnings amount to at least 20% of paid-in capital and contributed surplus. This provision may be viewed as a means of promoting capital growth.

3. Liquidity Control

As in the case of capital adequacy, the Bank Act requires every bank to maintain adequate and appropriate forms of liquidity, with parallel provision for the issuance of regulations and directives. To date neither regulations nor informal guidelines have been utilized, although liquidity is reviewed regularly as part of the bank examination process. Particular attention is currently being given to the question of maturity-mismatching, although internal studies show that Canadian banks typically engage in reverse interest rate mis-matching in the sense that liabilities tend to respond to interest rate changes with a greater lag than do assets.

4. *Permissible Business Activities*

The revised Bank Act sets out the powers of banks while also specifying certain restrictions on their activities. Subject to certain limited exceptions banks may not own more than 10% of the voting shares of any Canadian company; they cannot undertake insurance business, fiduciary activities or underwrite equities; and there are various restrictions on their dealings in securities and property holdings. However, the Act does permit banks to engage in factoring and leasing through wholly owned subsidiaries.

The limitations on Canadian banks' activities apply equally to their international operations.

5. *Foreign Currency Exposure*

There are no formal limits or informal guidelines relating to banks' foreign exchange exposure. On the other hand the authorities attach considerable importance to internal management controls (the OIB has carried out special inspections of control procedures in the big six Canadian banks); banks must submit their currency exposure limits as agreed by their respective Boards; and de facto exposure amounting in aggregate to over, say, 10% of capital would be a matter for official concern.

6. *Loan Concentrations and Country Risk*

There are no formal limits on the size of loan which a bank may extend to a single borrower and traditionally banks have attempted to meet the entire borrowing requirements of their customers. Equally, country exposures are not subject to any official ceiling although the authorities obtain consolidated exposure data each quarter and banks are expected to justify their country risk evaluation procedures. In addition, reliance is placed on the auditors' assessment of the foreign loan portfolio. The authorities themselves do not form an independent view of the credit standing of individual countries.

7. *Bank Examination*

The OIB has a statutory duty to inspect banks annually to ensure that the provisions of the Act relating to the safety of the creditors and shareholders are being observed and that the banks are in a sound financial condition. Each on-site inspection typically involves three examiners for a period of 2-4 days, with particular attention being given to the quality of loans. Inspections are confined to the bank's head office where all relevant information relating to branches and subsidiaries is expected to be maintained. Accordingly, inspections do not extend to domestic banks' establishments abroad. Bank examinations, together with quarterly statistical returns, form the basis of the supervisory process.

8. *Deposit Insurance*

Banks as well as federally incorporated trust and mortgage loan companies must become members of the Canada Deposit Insurance Corporation (CDIC). Insurance is limited to C$20,000 per depositor per institution (the ceiling is now under review) and the deposits must be made with an office located in Canada and denominated in Canadian dollars. Coverage extends to non-residents and to corporate and bank depositors. The CDIC is funded by an annual levy on member institutions although it also has powers to borrow from the Federal Government. The fund currently amounts to approximately 0.2% of insured deposits.

As part of its deposit protection function the CDIC has broad powers to acquire assets from and make secured or unsecured advances to member institutions for the purpose of reducing prospective losses to the Corporation.

9. *Lender of Last Resort and Emergency Measures*

The Bank of Canada Act confers on the Bank of Canada broad powers as lender of last resort. All loans must be made on a secured basis although the revised Bank Act has substantially broadened the range of eligible collateral for this purpose. The Bank of Canada recently formalized the terms on which it will lend as follows:

Lines of credit are extended by the central bank to each chartered bank and to each member of the Canadian Payments Association that participates directly in the daily clearing of payments' items and maintains an account at the Bank of Canada for this purpose. The lines of credit for each institution are the greater of: (a) 2½% of its checkable deposits; (b) 10% of its average primary reserve requirement; and (c) C$1 million.

"Ordinary" advances by the Bank of Canada shall not exceed the institution's line of credit; the advance is for one business day; there are restrictions on the frequency of drawings; the rate charged is Bank Rate; and collateral consists of securities issued or guaranteed by Canada or a province of Canada.

"Extraordinary" advances are advances that do not meet these conditions, for instance because the line of credit is exceeded, the term is for longer than one business day or the security is otherwise than above. In such cases the rate charged will normally be above the Bank Rate.

The CDIC also has a lender of last resort function (above). This was recently exercised in the case of the Astra Trust Company which, however, was eventually liquidated in July 1980. Due partly to the high level of industry concentration there has been no bank failure since 1923.

Foreign banks are required to provide non-legally binding letters of comfort covering their Canadian bank subsidiaries. The Canadian authorities would accordingly look first to the parent institution for support in the event that a foreign bank subsidiary experienced liquidity difficulties going beyond unexpected clearing swings.

C. France

Supervision of the French banking system is complicated by a multiplicity of regulatory bodies as well as by various categories of banking institution. The Treasury and the Bank of France, together with the Conseil National du Crédit (CNC) and the Commission de Controle des Banques (CCB), are charged with responsibility for regulating commercial banks although since the Bank of France provides the secretariat both of the CNC and the CCB it has in practice a pre-eminent role in day-to-day supervisory matters. The Association Française des Banques (AFB), being the key link between the authorities and the banks, also has a formal role to play in the supervisory process.

The commercial banks are legally categorized into deposit banks, investment banks and medium and long-term credit banks. However, restrictions on the permissible activities of each type of institution (for instance the extent to which investment banks must rely on term rather than sight deposits) have been eased in recent years and the functional distinctions have become correspondingly less important. The co-operative, savings and other specialized banks falling outside the commercial banking sector are subject to separate regulatory arrangements.

The nationalization bill will leave about 10% of the commercial banks' deposit business in the private sector. This legislation apart, the

Government plans to introduce a new banking law in 1982 whose scope has yet to be determined, but which will aim to rationalize the complex structure of the domestic banking industry.

1. Entry Controls

All commercial banks must be authorized by the CNC. The authorization requirements include: (a) minimum capital, the amount of which depends on the bank's legal form, the number of branches and its balance sheet total; (b) a reputable management; and (c) a judgement by the CNC that the application is justified by general and local economic needs (in practice rarely invoked as a reason for refusing authorization). These criteria apply equally to foreign banks seeking to establish branches or subsidiaries in France. French banks establishing branches abroad do not require the prior authorization of the CNC.

2. Capital Adequacy

A new solvency regulation was introduced in 1979 and this is currently being operated by the CCB on an experimental basis. The regulation establishes a risk assets/capital ratio target of 5% which banks are required to move towards in specified stages. For this purpose assets are accorded different weightings depending on their risk category: for instance, ordinary advances, including loans to foreign governments, are accorded a weighting of 100%, inter-bank loans are subject to a weighting of 5% and loans to or guaranteed by the French government and certain public sector bodies are given a zero weighting.

Capital is defined to include share capital, reserves, general provisions and (to a theoretically unlimited extent) subordinated debt, with a deduction for investments in banking subsidiaries and affiliates. There is no mandatory consolidation for the purpose of calculating the solvency ratio, although banks may be assessed on this basis if they so choose. French branches of foreign banks may be exempted from the solvency ratio requirement on condition that (a) solvency is adequately regulated in the country of origin and (b) the parent bank gives a formal guarantee to support its French branch.

3. Liquidity Control

The CCB has introducted two liquidity ratio requirements under its statutory authority to regulate banks. The first relates liquid assets (defined to include cash, inter-bank deposits of under three months' maturity, rediscountable paper and various marketable securities) to short-term liabilities (liabilities at sight and due within three months) and specifies that, in the case of investment and deposit banks, liquid assets must at all times equal at least 60% of short-term liabilities. The second requirement, which applies to all commercial banks, relates certain medium and long-term loans to capital plus savings accounts (essentially deposits with over three months to maturity) and specifies that if the former exceeds the latter by a factor of more than three, then an alternative liquidity rule must be met. This in turn specifies that 80% of medium and long-term loans must be covered by capital plus savings accounts plus inter-bank borrowings with at least two years to maturity.

These rules are subject to special procedures where foreign currency assets or liabilities exceed 10% of a bank's balance sheet. In such cases the 60% liquidity ratio applies only to French franc items, the foreign currency business then being monitored rather than regulated, while the medium-term liquidity co-efficient must be calculated separately for both French franc and foreign currency transactions.

The liquidity rules apply only to French banks' domestic operations and therefore exclude the activities of their foreign branches. Nor are French branches of foreign banks assessed for liquidity. On the other hand French subsidiaries of foreign banks are in principle subject to the above requirements and in order to ensure that the medium-term liquidity co-efficient is met in respect of foreign currency business the CCB may demand a guarantee or stand-by line of credit from the parent bank.

In addition to the above liquidity rules, banks have since 1967 been prohibited from paying interest on sight deposits. This restriction is designed to encourage reliance on longer term deposits and thereby reduce the degree of maturity mismatching in banks' balance sheets.

4. *Permissible Business Activities*

Banks are in general prohibited from directly engaging in activities which have no connection with banking. However, deposit banks may purchase holdings in non-bank companies up to a ceiling of 20% of the share capital of any one company, so long as the total amount of such holdings does not exceed the investing bank's capital. Investment banks may hold 100% of the share capital of a company but must not finance non-bank equity holdings with sight deposits and term deposits due in less than two years. Deposit banks are not permitted to invest their sight deposits, or term deposits due in less than two years, in property.

5. *Foreign Currency Exposure*

Although, for balance of payments reasons, French banks are prohibited from taking open positions against the French franc, they are permitted to take positions in one foreign currency against another. Such exposure is nevertheless monitored closely by the authorities who may intervene where risks are considered excessive.

6. Loan Concentrations and Country Risk

Under a new standard introduced in 1979, no customer may account for a risk equal to more than 75% of a bank's capital, although the rule does not apply where the risk amounts to 5% or less of the bank's total risk exposure to all customers and to 50% or less of the customer's bank debts. In addition, the total of individual risks in excess of 25% of capital must be less than 10 times capital. Inter-bank lending is excluded for the purpose of these calculations.

The loan limits are not in practice applied to country risk exposure although arguably the CCB could choose to interpret them in this way on the grounds that borrowers from the same country are financially linked. At present country risk exposure is not monitored on a consolidated basis and the authorities do not, as a matter of course, assess banks' country risk evaluation procedures. More generally, country risk evaluation is considered to be a matter for bank management rather than the regulatory authorities.

7. Bank Examination

Bank auditors do not have a special role to play in the supervisory process and the CCB therefore relies on on-site examinations by the Bank of France's inspectorate to verify prudential returns, assess internal control procedures and examine the quality of loans. Inspections may be ad hoc or routine (though the frequency may vary between 1-2 years and 10 years), they are generally confined to the bank's head office and do not extend to the foreign branches or subsidiaries of French banks. Since the enactment in 1980 of a law restricting the provision of commercial information to other countries, foreign supervisory authorities have not been permitted to undertake on-site bank inspections in France.

8. Deposit Insurance

There is no official deposit insurance scheme covering French banks. However, the AFB set up its own deposit protection arrangements in 1979 when it became clear that the Treasury and the CNC were considering the establishment of an official scheme. The AFB arrangements, which were formulated jointly with the authorities, are territorial in scope and therefore embrace all banks, including foreign banks, operating in France while excluding foreign branches of French banks.

Deposits are protected up to a ceiling of FF200,000 per depositor per institution subject to the exclusion of inter-bank deposits, certificates of deposit and foreign currency deposits. There is no deposit protection fund and participating banks are required to contribute directly to any deposit pay-offs according to a graduated scale, based on each bank's deposit total, which in effect favors larger banks against the smaller. The scale of contributions, incorporating an absolute cut-off point beyond a specified deposit total, is designed to reflect the low riskiness of the large nationalized banks relative to the smaller private banks.

Since the scheme's inception in 1979 there have been six instances of (small) bank failures where the AFB has paid off depositors.

9. Lender of Last Resort and Emergency Measures

Under the French system of monetary control, which is based on quantitative credit ceilings, banks have automatic and unlimited access to official credit through the sale of eligible commercial paper to the Bank of France. In such a context it is difficult to distinguish the lender of last resort function from the normal functioning of credit markets. However, in 1974 the Bank of France did lend to one troubled institution on the basis of non-eligible paper at a special rate and in other cases the central bank may, in principle, provide support through the intermediation of one or other of the larger banks. The significance of the lender of last resort role will in any event be reduced as a result of nationalization.

Among other protective measures available to the authorities is the regulation of deposit interest rates. For instance the CNC recently increased the maximum size of deposit subject to interest rate regulation from FF100,000 to FF600,000 with a view to reducing banks' vulnerability to sharp increases in their cost of funds.

D. Germany

The Federal Banking Supervisory Office (SO) is charged with the supervision of banks, although it exercises its functions in close cooperation with the Bundesbank. Thus while the banks' financial reports are collected and evaluated by the Bundesbank, they are passed on to the SO whose responsibility it is to take appropriate steps in the light of such reports. Similarly, it is the SO's responsibility to issue detailed regulations on liquidity and capital adequacy, but only after reaching agreement with the Bundesbank.

Present supervisory arrangements reflect a number of reforms introduced in 1976 after the Herstatt crisis, including rules on risk-spreading and foreign exchange exposure, the establishment of a lifeboat fund for banks experiencing liquidity difficulties, and an extended deposit protection scheme. More recently these arrangements have been supplemented by a series of "gentlemen's agreements" aimed at extending the supervisory function to domestic banks' foreign operations. More far-reaching legislative reforms embodying proposals of the Commission of Enquiry into Basic Banking Questions (the "Gessler Commission") are expected to be incorporated in a new Bank Act in due course.

German branches of foreign banks are supervised and regulated as if they were domestic banks, and must comply with prudential ratios in the normal way. Under German law, too, such branches are subject to separate liquidation proceedings and head office claims subordinated to those of branch depositors.

1. Entry Controls

Any person wishing to conduct banking business requires a license from the SO. The SO can refuse a license only if one or other of the following criteria are not fulfilled: (1) adequate capital (a minimum of DM6 million is currently applied); (2) a trustworthy and professionally qualified management; and (3) at least two managers actively involved in running the business. Although the SO does not have a discretionary authority to reject license applications, it may subject any license to conditions which in the case of private commercial banks will normally include membership of the Deposit Protection Fund (below). German branches of foreign banks are subject to the same licensing criteria as domestic banks, for which purpose the head office must supply its branch with the appropriate amount of dotation capital. In addition, a license may be (but seldom is) refused to the branch of a foreign bank incorporated outside the EEC if "not justified in view of the overall needs of the /German/ economy".

2. Capital Adequacy

The basic capital adequacy rule is that loans and participations should not together exceed 18 times equity capital plus reserves (subordinated debt is not included). However, certain secured and guaranteed loans as well as loans to foreign banks are assessed for this purpose at only half their value, while loans to domestic banks (including domestic branches of foreign banks) are assessed at only 20% of their value. Furthermore, loans to the public sector are exempt from any capital requirement. After allowing for such adjustment capital ratios may de facto fall significantly below the implied basic minimum of 5.6%. Failure to comply with the requirements creates a rebuttable presumption that the equity capital of the bank is insufficient and must be corrected.

German branches of foreign banks are, for reasons of competitive equity, subject to the same capital requirements as domestic banks. Branch capital is defined as (1) the working capital made available to the branch by its foreign parent plus (2) operating surpluses retained by the branch less (3) any net claims by the branch on intercompany account.

Until now the capital adequacy criteria have not been applied on a consolidated basis, nor does the SO have the statutory authority to do so. However, the Gessler Commission recommended consolidation for this and other supervisory purposes and pending legislative reforms the commercial banks have voluntarily undertaken to provide consolidated financial data in respect of wholly or almost wholly owned subsidiaries. It is intended that this data should in due course provide the basis for assessing capital adequacy.

3. Liquidity Control

There are two basic liquidity rules which together limit the extent of maturity transformation in a bank's balance sheet while also recognizing that some proportion of shorter term liabilities may be viewed as a stable funding base. The first rule states that specified long-term assets should not exceed the sum of long-term financial resources, as defined, and the second requires that certain other non-liquid assets be backed by appropriate financial resources, comprising specified proportions of different liability categories. A central feature of this formula is that bank liabilities are classified both by maturity and velocity of turnover with a view to determining the extent to which they may prudently be used as a basis for maturity transformation. As with capital adequacy, failure to conform to the liquidity guidelines carries a presumption that corrective action is needed. There are currently no plans for assessing liquidity on a consolidated basis.

4. Permissible Business Activities

Universal or multi-purpose banking is an established feature of the West German financial system. The Gessler Commission examined the desirability of imposing constraints on the kinds of business (particularly securities business) that banks could undertake but fundamental legislative reforms were not recommended and are not to be expected in this area.

5. Loan Concentrations and Country Risk

Every 'large' loan, defined as a loan to one borrower exceeding 15% of the lending bank's capital, must be reported immediately to the supervisory authorities. Furthermore, no single loan should exceed 75% of a bank's capital while the five largest loans and all 'large' loans together should not exceed, respectively, three times and eight times a bank's capital. These limits are now calculated on a consolidated basis but they do not apply directly to country risk where several borrowing entities from one country may be involved.

Country risk is monitored on the basis of exposure data classified by various country groupings (EEC, other industrial, developing, OPEC and Comecon). However, it has not so far proved possible to obtain consolidated data on loans to individual countries or even groups of countries, due partly to local bank secrecy laws. The auditors' reports to the SO must refer to the methods used to evaluate country risk, although the authorities do not themselves take an independent view on individual countries' financial prospects.

6. *Foreign Exchange Exposure*

A bank's net open position in foreign currencies and precious metals, irrespective of the maturity of individual commitments, should not in aggregate exceed 30% of capital. Furthermore, in order to minimize the fulfillment risk arising from differing maturities of assets and liabilities, even where the positions are matched in amount, net foreign currency positions maturing in any calendar month or half year should not exceed 40% of capital. Since net long as well as net short positions in individual foreign currencies are aggregated for the purpose of these calculations, the effective maximum long or short position in one foreign currency or group of foreign currencies against other foreign currencies is 15% rather than 30% of capital. In contrast, a banks' aggregate long or short position in foreign currencies against the Deutschemark may be as high as 30% of capital.

7. *Bank Examination*

Bank supervision is based on annual auditors' reports to the supervisory authorities rather than on-site examinations by the regulators themselves. Bank auditors are required by statute to report breaches of the law, facts which might endanger the existence of a bank and, at the request of the authorities, any other facts which suggest that the business of the bank has not been conducted properly. Under a recent amendment to the law the SO may itself carry out spot checks by conducting its own audits without any special reasons being given.

8. Deposit Insurance

There is no statutory scheme for deposit insurance but the banking associations for the private commercial banks, savings banks and credit associations have, with official encouragement, each set up their own voluntary deposit protection schemes. The Federal Association of German Banks has established a Deposit Protection Fund for the private commercial banking sector which protects non-bank deposits with member institutions up to a limit, per depositor, of 30% of a bank's stated equity capital. The scheme is funded by an annual membership levy and in the case of German subsidiaries of foreign banks (whose licensing terms generally require participation) legally binding letters of indemnification are sought from the parent requiring it to reimburse any payments by the fund to the subsidiary's depositors.

The coverage of the Deposit Protection Fund extends to foreign branches of German banks, foreign currency deposits and deposits by non-residents. However, there are also some limitations: most but not all private commercial banks participate; the potential pay-out is limited by the size of the Fund; and the pay-out is at all times discretionary not mandatory.

10. Lender of Last Resort

In the aftermath of the Herstatt collapse, when a number of banks had to be given liquidity assistance on an ad hoc basis, the Bundesbank joined with the domestic banking industry in setting up the Liquidity Consortium Bank (Liko-Bank). The sole function of this institution is to give assistance to banks that have run into temporary liquidity difficulties but are otherwise sound, for which purpose it can engage in all normal banking transactions. The Liko-Bank's equity capital, 30% of which is subscribed by the Bundesbank, amounts in all to DM1 billion (DM250 million paid up, DM750 million unpaid). In addition it has been granted a special rediscount ceiling by the Bundesbank, a facility which reflects the central bank's continuing role as lender of last resort.

The Liko-Bank may offer support to any bank licensed to do business in Germany, including branches of foreign banks. Foreign branches (but not subsidiaries) of German banks are also eligible for support. There is no legal constraint on lending in foreign currencies, although such activity is not presently envisaged.

E. Hong Kong

Apart from its traditional role as a lending rather than a funding center — an emphasis that may now change with the abolition of with-holding tax on offshore deposits—Hong Kong has a number of characteristics that distinguish it from other financial centers such as Singapore. Firstly, there is no separation of domestic and offshore banking business, so that foreign banks may engage freely in both. Secondly, Hong Kong is not merely host to a large number of foreign banks but is also the headquarters of several large banks, notably the Hong Kong and Shanghai Bank (Hong Kong Bank) with substantial branching operations abroad. Thirdly, because there is no central monetary authority, the Hong Kong Bank fulfills several central banking functions.

Prudential regulation is based on the Banking Ordinance which is administered by the Commissioner of Banking (CB). For regulatory purposes there was until recently a two-tier banking structure comprising licensed banks and registered deposit-taking companies (DTCs). However, the rapid growth of DTCs raised concerns about the size and stability of the secondary banking sector and led to a new distinction between licensed and registered DTCs as well as to a number of restrictions on registered DTCs that were designed both to reduce the scale and lengthen the term of their deposit-taking business. The new banking structure comprises 125 licensed banks, an emergent group (currently 8) of licensed DTCs or merchant banks and 346 registered DTCs. Only the licensed banks can accept short-term retail deposits.

Reflecting the importance of local banks' overseas operations, the Banking Ordinance was amended in early 1982 with a view to strengthening the CB's supervision of these activities. At the same time the CB's discretion to allow foreign supervisors to inspect banks in Hong Kong was formalized. Both these initiatives were designed to conform to the principle of parental responsibility in supervisory matters.

1. *Entry Controls*

Bank licenses are issued by the Governor in Council on the advice of the CB. Although there are a number of criteria that must be met before a license will be granted the decision whether or not to grant remains discretionary and from time to time the authorities have declared moratoria on new licensing with a view to avoiding excessive competition within the banking industry. Licenses are granted only in respect of branches, not subsidiaries, of foreign banks on the grounds that branches enjoy the full support of the group to which they belong. Such branches may be licensed only if (a) the parent bank is effectively supervised in its country of origin and the parent supervisors have no objection; (b) the parent bank has total assets of at least US$10 billion; and (c) some acceptable form of reciprocity exists. Locally incorporated banks, on the other hand, must have paid-up share capital of at least HK$100 million, deposits from the public of at least HK$1.5 billion and total assets of HK$2 billion, and they must have been in the deposit-taking business for at least ten years.

2. Capital Adequacy

A licensed bank incorporated in Hong Kong is required to appropriate at least one third of its published earnings each year to a published reserve until the paid-up capital and published reserve together amount to HK$200 million. In addition, banks are encouraged to maintain inner reserves which can be used to absorb unexpected losses. Beyond this the CB has recently been given statutory powers to obtain detailed information from locally incorporated banks relating to their overseas subsidiaries and affiliates. It is intended that such data should in due course permit the introduction of a capital ratio to be applied on a consolidated world-wide basis. The capital adequacy of banks incorporated outside Hong Kong is, however, viewed as a matter for the parent bank's supervisory authorities.

3. Liquidity Control

Hong Kong's liquidity rules, which relate to monthly averages, have a prudential rather than a monetary function. The rules embrace foreign as well as local currency business and they apply also to local branches of foreign banks which for this purpose are deemed to be separate entities. Banks must hold the equivalent of 25% of their deposits in the form of liquid assets realizeable within seven days and 15% of their deposits (included in the 25%) in the form of highly liquid assets realizeable on demand. The amount of liquid assets is calculated after deducting short-term interbank borrowings from other banks in Hong Kong. Highly liquid assets include cash, gold and demand and call money at other banks, while the broader category of liquid assets includes money at short notice at other banks, certain export bills of exchange, various government or government-guaranteed securities which are deemed to be realizeable within seven days, and such money market instruments as the Financial Secretary may specify.

4. Permissible Business Activities

There is no formal separation of commercial and investment banking in Hong Kong. A bank must not engage in any wholesale or retail trade but can provide most financial services, including the underwriting of securities, so long as the book value of its non-bank shareholdings does not exceed 25% of its capital and reserves. A similar 25% limit applies to holdings of property (excluding bank premises) while unsecured lending to directors, their relatives and related companies is limited to 10% of capital and reserves. All three classes of restricted asset are subject to an aggregate limit of 55% of capital or 80% if account is also taken of property used as banking premises.

5. *Loan Concentrations and Country Risk*

For both banks and DTCs there is a maximum lending limit to any one customer of 25% of capital and reserves. For an institution incorporated outside Hong Kong the limit is measured against the capital of the head office in the country of incorporation. Locally incorporated but foreign-owned DTCs are expected to provide letters of comfort from their parent shareholders and in such cases the 25% limit is waived. These letters of comfort are not legally binding although they must be the result of a board decision and be issued with the knowledge of the parent institution's supervisory authority.

The loan concentration limit does not apply to country risk where several borrowing entities are involved. Country risk exposure is not at present regulated, although consolidated exposure data is provided for BIS purposes.

6. *Foreign Currency Exposure*

Non-consolidated foreign currency exposure data is collected on a month-end basis but there are no guidelines in this area. Formal exposure limits might be expected to give rise to difficulties in that the Hong Kong Bank, which in effect holds the banking system's residual liquidity offshore, has a naturally long position in foreign currencies (windfall profits and losses from this exposure being taken into or absorbed by hidden reserves).

7. *Bank Examination*

The CB, who has 24 examination teams, each comprising 4 examiners, aims to examine locally incorporated banks (and DTCs) once every 12 months and branches of foreign banks once every 24 months. In March 1982 the CB was also given powers to inspect the foreign branches (but not subsidiaries) of locally incorporated banks. This new legislation formalizes the existing practice of allowing appropriate foreign supervisory authorities to inspect the Hong Kong branches or subsidiaries of banks incorporated in their jurisdiction. It also relaxes the domestic secrecy laws so as to permit the CB to provide information on local banks to appropriate foreign supervisory authorities.

8. Deposit Insurance

Hong Kong has no formal deposit protection scheme. When the possibility of introducting such a scheme was raised after the 1965/66 financial disturbances the larger banks objected and the matter was not pursued further. In one of the bank failures of 1965/66 depositors did lose approximately one third of their money, but in a subsequent failure, when the authorities were particularly concerned about possible adverse confidence effects, means were found of protecting depositors in full.

9. Lender of Last Resort

The day to day lender of last resort is the Hong Kong Bank which, in fulfilling its clearing function, may provide liquidity assistance on terms of its choosing to any bank faced with a funding shortfall at the daily clearing. Beyond this the Hong Kong Bank may, either on its own initiative or at the Government's behest, provide emergency assistance on a longer term basis or, where more protracted difficulties are evident, acquire the troubled bank (as happened with Hang Seng Bank in 1966). The true lender of last resort is, however, the Hong Kong Government whose Exchange Fund currently amounts to some HK$35 billion (the precise figure is not disclosed), most of which is invested in US dollars. In 1965, the Government exercised its lender of last resort role by depositing sterling funds in London for the use of the Hong Kong Bank and the Chartered Bank who at that time were providing liquidity assistance to a number of other Hong Kong institutions.

F. Italy

The Bank of Italy is responsible for regulating the domestic banking system, subject to directives from the Inter-Ministerial Committee for Credit and Savings (ICCS) and within the framework of the Banking Law of 1936. The Banking Law draws a distinction between short-term and longer-term banking business: banks entitled to accept short-term deposits (defined as up to 18 months) are not permitted to accept medium or long-term deposits and their term lending beyond 18 months is also subject to restrictions.

The structure of the banking system is complex and, at the regional level, highly fragmented. There are some 900 rural, co-operative and savings banks, over 100 privately owned commercial banks and 31 commercial banks (including the four largest) controlled either by the Treasury or the state industrial conglomerate, IRI.

1. Entry Controls

Banks may not commence business or open new branches without prior authorization, the main criteria being (1) minimum capital, (2) a reputable management and (3) economic justification. The Bank of Italy has not laid down a uniform minimum capital requirement, although branches of foreign banks must possess dotation capital of at least $12 million. Since 1966 the economic need criterion has been invoked to withhold all new bank authorizations, other than those for branches of foreign banks. In addition, the Bank of Italy has confined banks' domestic branching activities to prescribed geographic regions, with a view to avoiding excessive competition which might threaten the stability of the banking system.

Italian banks seeking to establish foreign branches/subsidiaries must obtain the approval of the Bank of Italy which is in practice granted only to the larger institutions. The authorities have recently sought to increase the transparency of banks' foreign operations by limiting the scope for multiple subsidiary holdings.

2. Capital Adequacy

The Bank of Italy has statutory powers to lay down minimum capital ratios, subject to the approval of the ICCS. However, no formal ratios have been established, the official view being that standardized capital adequacy requirements are inappropriate to a heterogeneous banking system such as Italy's; that such requirements might prove to be an unacceptable burden given the various constraints imposed on banks' balance sheets for monetary policy purposes; and that the concentration and liquidity ratios (among others) already provide banks with an incentive to maintain their capital base.

The Bank of Italy monitors capital adequacy on the basis of both gearing and capital/risk assets ratios. Capital is defined to include reserves (undisclosed reserves are no longer allowed) and general provisions, but loan capital is not permitted. One of the main objectives of the monitoring process is to identify those banks whose capital ratios are significantly below their category average.

3. Liquidity Control

Although there is no formal prudential liquidity requirement, the Bank of Italy does monitor banks' liquidity on the basis of seven separate ratios. For this purpose foreign currency and local currency items are considered both separately and in the aggregate while a distinction is also made between primary and secondary liquidity. In the case of the broadest liquidity measure - the ratio of total liquidity to deposit liabilities plus funds of third parties managed by the bank - a minimum co-efficient of 15% is expected.

Banks entitled to accept short-term deposits may now make medium-term loans, with maturities ranging from 18 months to five years, but only up to a total of between 10 and 15% of their deposit liabilities. The precise limit is calculated according to a scale based on the lending banks' capital ratio. Foreign offices (including branches) of Italian banks are not covered by this restriction on medium term lending.

4. *Permissible Business Activities*

In practice the Bank of Italy does not permit banks to engage in business other than banking and equity participations in non-bank companies are generally limited to complementary activities such as data processing. Beyond this, banks are entitled to make share purchases of up to 2% of a company's share capital but such holdings must not in total exceed 100% of the acquiring bank's capital. Banks are not normally permitted to invest in property other than their own premises.

5. *Loan Concentrations and Country Risk*

Loans to a single customer may not exceed the lending bank's capital without special authorization from the Bank of Italy. Furthermore, 'large' loans (defined as those exceeding 20% of capital) may not in total exceed a ceiling varying between 25 and 40% of non-bank deposits, the precise limit depending on the bank's capital ratio. These loan limits are not, however, directly applicable to country risk exposure involving several borrowing entities from the same country. The authorities do not monitor such exposure on a consolidated basis and although a survey was recently conducted of banks' country risk evaluation procedures, the area of country risk is viewed as being the responsibility of bank management rather than of bank regulators.

6. *Foreign Currency Exposure*

No formal prudential limits are applied although net positions in individual currencies must be reported at least monthly and foreign exchange activity is strictly regulated for exchange control purposes. In particular, banks may not take net positions against the lira and must maintain balanced positions in US dollars, in EEC currencies taken together and in other currencies taken together.

7. *Bank Examination*

On-site bank inspections, aimed inter alia at verifying prudential returns and assessing the quality of loans, are carried out by the Bank of

Italy on both an ad hoc and routine basis, the broad objective being to examine each bank's head office every 3-4 years. Foreign offices of Italian banks are not normally inspected, although under a recently concluded bilateral agreement the US and Italian supervisory authorities may inspect branches of their respective domestic banks on each other's territory.

8. Deposit Protection

The fact that over 50% of bank deposits are placed with public sector institutions has had an important bearing on the authorities' approach to deposit protection. The Bank of Italy's practice has been to encourage the merger of smaller banks facing financial difficulties or to arrange for support in other forms from larger institutions. In 1974 this procedure was formalized by a decree authorizing the Bank of Italy to extend special low interest loans to banks willing to acquire failing institutions where liquidation proceedings had already been initiated. One consequence of this approach is that there have been no deposit losses with domestic banks in recent years. Foreign branches, though not subsidiaries, of Italian banks are in principle covered by the subsidized loan scheme, as are Italian subsidiaries of foreign banks. Italian branches of foreign banks are, however, subject to other arrangements (below).

9. Lender of Last Resort and Emergency Measures

In instances of prospective bank failure/insolvency the Bank of Italy lends at a low interest rate to the acquiring bank, as described above. To accommodate temporary liquidity difficulties the central bank provides a line of credit to each bank based on its balance sheet size on which drawings may be made, backed by collateral in the form of public sector securities, at the official discount rate. The interest rate charged is subject to a graduated premium where frequent use is made of the facility.

Subsidiaries of foreign banks (of which there are very few) are not asked for letters of comfort from their parent banks, but branches of foreign banks are required to produce a declaration by their head office. This is in standard form and asserts that under its own law the head office is liable to the full extent of its assets for the liabilities of its Italian branch.

Under Italian law local branches of foreign banks are subject to separate liquidation proceedings, as in the case of Intra-Bank's failure where the Italian branch's assets were used to pay off all branch creditors before remission of the surplus to the main liquidator.

G. Japan

Japan has 76 domestic commercial banks, comprising 13 city banks and 63 regional banks. In addition there are 70 foreign banks, 10 long-term lending banks, 71 sogo or mutual banks and some 1,000 credit associations and co-operatives. The foreign banks are in effect confined to branch rather than subsidiary form, reflecting in part the authorities' preference for branches on prudential grounds.

The relatively small number of commercial banks has enabled the authorities to adopt a highly informal approach to bank supervision based on administrative guidance. For this purpose the Banking Bureau and the International Finance Bureau of the Ministry of Finance (MoF) are the main supervisory agencies, although the Bank of Japan (BoJ) also has a role in this area which it fulfills in close consultation with the MoF. The new Banking Law that came into effect on April 1st 1982 is intended, among other things, to shift the emphasis away from administrative guidance towards a more formal regulatory regime. However the new law does not have a great deal to say on the subject of prudential regulation and the MoF retains considerable discretionary powers regarding those matters which are covered. Furthermore, it remains to be seen how far informal guidance may continue to be given outside the new legal framework.

The Japanese authorities have accepted in principle the desirability of supervising banks on a consolidated basis. On the other hand, because foreign subsidiaries account for a relatively small proportion of Japanese banks' overseas operations, consolidated supervision has not yet been adopted in practice.

1. Entry Controls

All banks must be licensed by the MoF. The statutory licensing requirements are (1) adequate resources (a minimum capital of yen 1 billion is specified but this may be raised by Cabinet Order); (2) a reputable and competent management; and (3) an economic need criterion. The MoF may impose additional conditions in the public interest while foreign banks are subject to a reciprocity test as well as to any other special conditions that may be determined by Cabinet Order.

2. Capital Adequacy

The MoF does not impose formal capital ratios, nor does it assess capital adequacy on a consolidated basis. However, the following broad guidelines have been indicated:

(1) Banks should aim to keep the ratio of fixed assets to capital below 40%, with an upper limit of 50%.

(2) The ratio of capital to deposit liabilities should be maintained at 10% or more (for the major city banks, whose deposits represent some 75% of total liabilities, actual ratios appear typically to have been well below the target).

The MoF has also sought to encourage capital accumulation by offering guidance on maximum dividend pay-outs. Finally, it may be noted that the new ceilings on loans to a single borrower (below) have induced most of the major banks to increase their capital over the past 18 months. For the purposes of capital adequacy assessment, capital is defined as equity capital plus reserves, the issuance of subordinated debt being allowed only to the long-term credit banks.

3. *Liquidity Control*

As with capital adequacy, the MoF has declined to impose general liquidity norms, although it has encouraged banks to raise the ratio of current assets to total deposits to at least 30%. Following the disturbed financial conditions of 1974/75 the Japanese authorities have also sought to limit maturity mismatching in banks' Euro-currency operations, the guidance here being that 40% of term lending for one year or more should be funded by term deposits or other debt of over one year's maturity. This guideline applies to the foreign branches but not subsidiaries of Japanese banks, although foreign subidiaries have recently been requested by some host countries (for instance Switzerland) to increase their long-term borrowing. Finally, the concentration of domestic long-term lending in the long-term credit banks and trust banks is calculated to reduce maturity mismatching in the banking system as a whole.

4. *Permissible Business Activities*

Following the American pattern, the Securities and Exchange Act of 1948 prohibits banks from underwriting securities other than public sector bonds. However, the separation of commercial and investment banking is regarded as an historical accident rather than a prudential necessity and is currently under review. Already the distinction is becoming blurred in overseas markets where subsidiaries of Japanese banks underwrite Eurobonds and the European offices of Japanese security houses have, with MoF approval, applied for local banking status. This issue apart, the Banking Law prohibits banks from engaging in activities other than banking, as defined, while the Anti-Monopoly Law restricts banks' equity investments in bank-related businesses.

5. *Loan Concentrations and Country Risk*

The Banking Law provides for maximum lending limits to individual borrowers to be determined by Cabinet Order, subject to certain exemptions in respect of loans to or guaranteed by the public sector. The present ruling is that loans to a single borrower should not exceed 20% of capital in the case of commercial banks, 30% for long-term credit and trust banks and 40% for the one specialized foreign exchange bank (Bank of Tokyo). This differentiation reflects the traditional business roles of the institutions concerned - for instance the Bank of Tokyo has large exposures to the Japanese trading houses - rather than special prudential considerations. The loan limits applicable to Japanese branches of foreign banks are calculated on the basis of the banks' group capital.

The loan concentration rules are not directly relevant to banks' country risk exposure, although it has been reported that the authorities intend to apply comparable guidelines in this area. Country exposure data is not currently monitored on a consolidated basis and the authorities disclaim any responsibility for making an independent assessment of individual countries' financial prospects. However, banks' country risk evaluation methods are considered as part of the bank examination process.

The MoF has given extensive guidance on the overall volume of Japanese banks' new international lending (currently limited to 10-12% of the total syndicated loan market), the proportion of such lending to be directed to developing countries, the maximum participation of Japanese banks in individual syndications (recently raised from 20% to 50%), the desireability of Japanese banks exercising independent judgement by acting as lead managers/agents, and the size of spreads. Guidance in these areas reflects a number of concerns, notably the MoF's view that, because of their domestic business experience based on a rigid interest rate structure, Japanese banks are inclined to compete for volume in international markets without sufficient regard for price and quality.

6. *Foreign Currency Exposure*

Monitoring of foreign currency exposure embraces the foreign branches but not subsidiaries of Japanese banks. Each bank is given an absolute net (spot and forward combined) exposure limit based both on its volume of foreign exchange transactions and its capital base. A general norm, measured in terms of percentage of capital exposed, is not applied although as a matter of practice exposure is generally kept below 10% of capital.

7. *Bank Examination*

On-site bank examinations are of three kinds. The MoF's International Finance Bureau carries out inspections mainly in the area of foreign exchange dealings; the Banking Bureau undertakes a broader prudential examination; and the Bank of Japan (which has a separate inspectorate) makes a mainly qualitative assessment of loan portfolios and bank management. The Banking Bureau aims to examine the head office and randomly selected branches (including foreign branches) of domestic banks every 2-3 years. Japanese branches of foreign banks are examined every 5-6 years, although foreign supervisors may be permitted to carry out their own inspections.

8. *Deposit Insurance*

Since 1971, Japan has had a deposit insurance scheme which is jointly capitalized by the Government, the Bank of Japan and the banking industry. The coverage is non-territorial in that all yen deposits held by residents and non-residents with Japanese banks and their overseas branches are insured, while Japanese branches of foreign banks are excluded. Neither foreign currency nor inter-bank deposits are covered. There is a yen 3 million (approximately US$13,000) maximum payable to each depositor per institution, although in the absence of any recent bank failures no deposit pay-offs have had to be made. Participant banks contribute an annual levy (currently 0.008% of their insured deposits) to the insurance fund which now amounts to around 100 billion yen or 0.035% of total insured deposits. Given the modest size of the fund, the official intention is to raise the scale of contributions in stages over the next several years. The fund may, if necessary, be supplemented by borrowings from the BoJ although it has been officially stated that the system "is not intended to cope with a general financial panic."

9. *Lender of Last Resort*

Routine liquidity assistance is provided on a day-to-day basis by the BoJ at bank rate. For this purpose each bank, domestic and foreign, has a commercial bill discount quota based on the size of its yen assets. Foreign banks are given a proportionately higher discount quota because their yen assets are relatively small. Longer term liquidity assistance may also be provided at bank rate, although such lending must (in the absence of a special MoF waiver) be adequately collateralized. The BoJ regards itself as a lender of last resort in yen only, although if a bank experiences a liquidity short-fall in foreign currency the BoJ may, in principle, make yen available for conversion into foreign currency. During the international financial disturbances of

1974, when some Japanese banks experienced difficulties in securing dollar funds, the Bank of Tokyo provided large-scale liquidity assistance, borrowing dollars in its own name at a small margin over LIBOR and channelling funds to those banks in need.

H. Luxembourg

The Commissariat au Controle des Banques (CCB), in conjunction with the Ministry of Finance, is responsible for regulating and supervising the banking system. For this purpose the CCB is advised by the Conseil de Controle des Banques, which includes representatives from the banking industry.

The Luxembourg banking system has a number of features which have a direct bearing on the authorities' approach to regulation. The country is host to over 100 foreign banks and accounts for one quarter of all euro-currency credits to non-bank borrowers; over 85% of all banking business is denominated in foreign currencies, with the Deutschemark accounting for approximately half of the foreign currency total; and there is no central bank with the result that the authorities must look to foreign parent institutions (and their central banks) for support of their Luxembourg operations.

1. Entry Controls

The authorization requirements for banks wishing to establish themselves in Luxembourg include a reputable and competant management and a minimum capital which is currently set at 350 million francs, of which 250 million must be paid up. The relatively high minimum paid-up capital requirement applies equally to branches of foreign banks, and is designed to limit market entry to banks of substance. Under a recent amendment to the law each bank must also show that it has sufficient private credit lines for its own purposes, a provision which confers on the CCB a wide discretion to demand irrevocable stand-by credit lines. Authorization is also required for Luxembourg banks seeking to establish branches or agencies abroad.

2. Capital Adequacy

In addition to the minimum capital requirement, the CCB is authorized, with the approval of the Ministry of Finance, to set a mandatory solvency ratio (ratio of capital to liabilities) within a statutory range of 3 to 10%. Since its inception this ratio has been held at the minimum level of 3%. The ratio is applied to the combined assets and liabilities of

Luxembourg banks and their foreign branches and also to the branches of foreign banks, but is not calculated on a consolidated basis.

For this purpose capital is defined to include share capital, reserves, retained earnings and general provisions while subordinated debt due in over one year may, at the CCB's discretion, be included up to 50% of the amount of paid-up capital and reserves. Liabilities exclude fiduciary deposits as well as, in the case of branches of foreign banks, short-term liabilities to the bank's head office.

As a separate requirement, fixed assets plus participations must not exceed capital (excluding subordinated debt).

3. *Liquidity Control*

The CCB does not enforce any prudential liquidity ratios, although it has recommended that banks should hold liquid assets (as defined) equal to 30% of their liabilities.

4. *Permissible Business Activities*

There are no statutory restrictions on the type of business that a bank may undertake. Nor are there any restrictions on shareholdings in non-bank companies, although such participations are included in fixed assets and must therefore be covered by equity capital.

5. *Foreign Currency Exposure*

Banks' operations in the official market are subject to foreign exchange controls. There is no formal prudential regulation of foreign currency exposure in the free market (chiefly used for capital transactions) although banks' open positions, both spot and forward, are regularly reported and any position in excess of 30% of capital is monitored closely.

6. *Loan Concentrations and Country Risk*

There are no formal limits on loans to single borrowers although loans of more than 50 million francs (or, in the case of banks with capital below 500 million francs, loans equivalent to 10% or more of capital) must be reported to the CCB. Country risk exposure is not formally regulated.

7. *Bank Examination*

Routine examinations by the CCB take place annually and an independent audit of banks is also now mandatory (which was not previously the case). Foreign supervisory authorities are not permitted to inspect banks in Luxembourg and while the Luxembourg secrecy laws have been relaxed to enable subsidiaries of foreign banks to make more information on their lending available to their parent institutions, individual borrowers may not be identified. In addition, the Luxembourg authorities now have a broad discretion to disclose information about locally based banks to foreign supervisors. However, this discretion does not extend to revealing details of a bank's country exposure.

8. *Deposit Protection*

There is no official or privately organized deposit protection scheme, partly because most of the banking business conducted by Luxembourg banks is wholesale not retail. As a matter of practice, no deposit losses have been incurred in recent years.

9. *Lender of Last Resort*

The National Bank of Belgium, which has a branch in Luxembourg, provides liquidity support in respect of local currency banking and for this purpose is prepared to discount certain claims on or guaranteed by the Luxembourg government. There is, however, no support facility for the Euro-banks who must look to their parent institutions for liquidity assistance. The CCB does not demand letters of comfort for this purpose but under a recent amendment to the law it may require irrevocable stand-by credit lines (above).

I. The Netherlands

The Nederlandsche Bank is responsible for enforcing the Act on the Supervision of the Credit System which was substantially revised in 1978. The central bank's prudential responsibilities cover the universal banks, co-operative banks, savings banks and mortgage institutions, although in the case of the savings banks and certain co-operative banks, supervision has been delegated to the appropriate association. The supervisory system is in one sense highly formal, involving, for instance, detailed regulations on solvency and liquidity requirements, but the central bank also attaches considerable importance to its informal contacts with management.

Branches of foreign banks are, for prudential purposes, treated in the same way as domestic banks. The revised Act also confers on the creditors of such branches preferential rights to branch assets in the Netherlands, thereby offering some possibility of the recovery of their claims in the event that the parent institution should fail.

1. *Entry Controls*

In order to be licensed by the Nederlandsche Bank, commercial banks must have a minimum capital of Fl 500,000 (shortly to be raised) and a managing board consisting of at least two persons of proven expertise and trustworthiness. Branches of foreign banks must meet the same licensing criteria as domestic banks and for this and other purposes are required to maintain separate branch accounts, identifying the amount of dotation capital from their parent institutions.

2. *Capital Adequacy*

The solvency regulation requires that a bank's capital must at least equal the total value of its fixed assets. More importantly, assets are broken down into different risk categories against which capital must be held in proportions varying between 0% and 100%, with a norm for risk-bearing assets of 10%. Under this scheme loans to foreign entities are at present treated relatively favorably: for instance loans guaranteed by foreign public authorities or foreign banks are subject to a 5% capital requirement while loans to foreign governments and banks are exempt (although these exemptions are expected to be removed shortly). In addition to risk assets, certain contingent liabilities as well as uncovered foreign exchange positions are included in the ratio calculations. Large credits, as defined, attract a premium solvency requirement (below).

Solvency ratios are calculated on a consolidated basis, with consolidation of majority holdings and minority holdings of over 10% effected pro rata. Capital is defined, for the purpose of the regulation, to include paid-up capital plus reserves (published and hidden) plus subordinated debt but only in so far as (a) it does not exceed 100% of capital and reserves and (b) annual redemptions do not exceed 5% of capital and reserves (the latter constraint means that subordinated debt is in practice generally no more than one third of capital and reserves). For branches of foreign banks, capital is calculated after deducting funds channelled back to the head office.

3. *Liquidity Control*

The liquidity regulation distinguishes between non-liquid, broadly liquid and highly liquid assets, although the requirements relating to the last are not yet in operation. Highly liquid assets include balances at the central bank and giro institutions, call money, Treasury bills and notes due in 90 days or less, advances against such bills/notes, bank deposits due within one month and certain public sector loans due within three months. Broadly liquid assets consist of highly liquid assets plus rediscountable bills and notes, securities and advances against securities.

The precise regulations are complex but in essence liabilities are classified by both category and maturity band; certain non-liquid assets are then deducted from liabilities within the same maturity band; and the resulting net liability positions attract a liquidity requirement that varies according to both maturity band and category of liability. In general, net liabilities due within two years require a 20% backing of broadly liquid assets, and a 4% backing of highly liquid assets, but there is an exception, for instance, in the case of interbank liabilities due within one month where the requirement for broadly liquid assets is 100%.

The liquidity regulation is designed not merely to limit the extent of maturity mis-matching but also to guard against excessive reliance by banks on money market financing. In addition, it is intended to discourage undue deposit concentrations by imposing extra liquidity requirements on "large item" liabilities which individually amount to between 1% and 2% and together to 15% or more of total liabilities or which individually amount to over 2% of total liabilities.

4. Permissible Business Activities

There are no direct restrictions on the types of banking business that may be undertaken and in practice banks engage in a wide range of activities including securities business and underwriting. On the other hand, equity participations of 5% or more are subject to the approval of the Minister of Finance which has been automatically witheld in the case of investments in non-financial companies. However, this policy was relaxed in 1980 and limited equity stakes in non-financial companies are now permitted if certain specified conditions are met. A bank's total investments in fixed assets (including property and non-financial companies) must not exceed its capital, although property not used in the bank's own business is given a concessionary 33% weighting for this purpose (a provision now under review).

5. Loan Concentrations and Country Risk

Under the solvency regulations, a bank is subject to an additional solvency requirement if its loans to one borrower exceed 15% of capital, while loans to one borrower exceeding 25% of capital are not, in general, allowable without the central bank's prior approval. For this purpose only, the branch of a foreign bank is assessed on the basis of group not branch capital.

The rules on loan concentration do not apply directly to country risk. Furthermore, loans to foreign governments are free of any solvency requirement (an exemption which is under review). However, the central bank monitors country risk on the basis of half-yearly consolidated country exposure reports which banks have been required to submit since June 30, 1981.

6. *Foreign Currency Exposure*

There is no specific limit on banks' open foreign exchange positions but the central bank may require such exposure to be reduced where it exceeds the level considered appropriate for normal banking activities. In addition, the solvency regulation imposes a 2.5% capital requirement on uncovered foreign exchange positions. Banks report monthly on their positions, forward and spot, in all convertible currencies and copies of certain forward contracts must also be forwarded.

7. *Bank Examination*

The central bank has broad powers to inspect banks with a view to verifying returns received and, as a matter of practice, on-site inspection forms an integral part of the supervisory process. In addition, annual accounts must be drawn up according to a specified model by registered accountants who can be required by the central bank to supply any information that may reasonably be considered necessary for the central bank to carry out its duties. In the case of foreign banks, on the spot inspections are freely allowed to parent supervisors.

8. *Deposit Insurance*

The revised Act on the Supervision of the Credit System provided that, in the absence of a voluntary deposit insurance scheme, a Government scheme should be introduced. The voluntary (but comprehensive) scheme that came into effect at the beginning of 1979 applies to all banks and credit institutions in the Netherlands, including branches of foreign banks; it guarantees all deposits by individuals (but not companies) up to 30,000 guilders (index-linked) per depositor per institution; and it makes no distinction between resident and non-resident depositors or between guilder and foreign currency claims. However, deposits held with the foreign branches of Dutch banks are not covered. The scheme is not funded but is administered by the central bank which advances payments prior to apportionment among participant institutions. There is a maximum annual contribution per institution measured as a percentage of capital, designed to prevent contagious financial difficulties: any excess above this ceiling is funded by the central bank.

9. *Lender of Last Resort and Emergency Measures*

Section 15 of the Bank Act of 1948 gives the Nederlandsche Bank broad powers to provide liquidity assistance. However, Section 16 of that Act states that "the Bank shall grant no credit or advances without security", there being no further guidance on what constitutes security for this purpose. There have been only two recent bank failures in the

Netherlands, official support being provided prior to liquidition in one of these cases.

The authorities are authorized to regulate interest rates on demand deposits if excessive competition is threatening the stability of the credit system. Other emergency provisions include, in the case of troubled banks, the appointment of receivers with full management powers where, for instance, an arranged merger may be considered preferable to conventional bankruptcy proceedings.

J. Singapore

The Singapore banking system separates local banking business from international or offshore operations. This dual structure enables the authorities to promote Singapore's role as an international financial center while avoiding excessive competition in the domestic market. Accordingly within the commercial banking sector foreign-owned banks are in general prevented from engaging freely in local currency business, the precise limitations depending on whether the bank has a full, restricted or offshore licence. On the other hand any commercial bank can apply for an Asian Currency Unit (ACU) licence enabling it to set up a separate book-keeping unit authorized to participate in the Asian dollar market. Since 1974 Asian dollar deposits have been expanding at around 35% per annum and now, at some US$85 billion, account for 6% of the total Euro-currency market.

Foreign-owned commercial banks are confined to branch form on the grounds that a branch enjoys the full support of the group to which it belongs. There is, however, a separate category of locally incorporated merchant banks which are not permitted to accept deposits from the public but which can (and typically do) set up their own ACUs. Merchant banks currently account for around 11% of the Asian dollar market.

The Monetary Authority of Singapore (MAS) fulfills all the functions of a central bank, other than the issue of currency, and is also responsible for supervising the banking system within the framework of the 1970 Banking Act. In carrying out its supervisory function the MAS has recently adopted a policy of deregulation in the sense that detailed supervision of individual institutions is being replaced by generally applicable guidelines and greater reliance is being placed on external auditors in lieu of extensive prudential returns. At the same time responsibility for the supervision of foreign-owned banks is being shifted more to the parent institutions and their home supervisory authorities. In addition the Banking Act is under review and a number of changes relating, inter alia, to capital and liquidity adequacy are expected in due course.

1. *Entry Controls*

All banks are licensed by the MAS and for this purpose have to meet certain statutory capital requirements. Locally incorporated banks must possess paid-up capital of at least S$3 million while branches of foreign banks are subject to a S$6 million group capital requirement, S$3 million of which must be held in the form of approved assets in Singapore. In practice, however, the MAS may insist on more stringent capital requirements than the statutory minima. In addition, foreign banks wishing to establish an office in Singapore must be substantial and internationally reputable institutions. Finally, foreign-owned banks are expected to provide letters of comfort from their parent institutions undertaking to make good any local or foreign currency liquidity shortfall in their Singapore establishments. Reflecting the authorities' increased emphasis on the principle of parental responsibility the form of these undertakings has recently been hardened (a main Board resolution is, for instance, required) to the point where they are considered to be legally binding by some of the banks concerned.

2. *Capital Adequacy*

The MAS is authorized to impose mandatory capital ratios but has so far declined to adopt any general norms for commercial banks. However, commercial banks must maintain a reserve fund to which they are required to transfer at least 50% of annual net profits, so long as the fund is less than 50% of paid-up capital. If the reserve fund is between 50% and 100% of paid-up capital, the transfer need only be 25% of net profits and if the fund exceeds paid-up capital, the transfer can be reduced to 5% of net profits. Foreign incorporated banks may apply for exemption from these requirements.

Foreign-owned merchant banks are subject to a maximum gearing ratio which is set at 15x, 30x or 50x depending whether a letter of comfort has been obtained from the parent institution and whether the bank itself is an affiliate or a wholly-owned subsidiary. It is expected that some form of capital ratio requirement will in due course be applied to commercial banks.

3. *Liquidity Control*

All banks are required to maintain a minimum cash balance with the MAS, which is currently set at 6% of the banks' liability base. This ratio is used by the MAS as an instrument of monetary policy for the regulation of bank liquidity. Banks are also required to hold a minimum/ amount of liquid assets equivalent to 20% of their liability base, half of which must be in the form of primary liquidity (excess cash balances with the MAS, notes and coins, money at call with the discount houses, Treasury bills and other Government securities with less than 12 months to maturity). Secondary liquidity includes commercial bills (up to 5% of the liabilities base) and Government securities of over 12 months to maturity. The liquidity ratio serves prudential and monetary purposes, although ACUs as well as merchant banks are exempt from both the cash and liquidity requirements.

4. Permissible Business Activities

There is no separation of commercial and investment banking but banks are prohibited from engaging in wholesale or retail trade and may not hold equity interests in non-bank undertakings exceeding in the aggregate 40% of the investing bank's capital funds. A bank's property investments (excluding business premises) are limited to 40% of its capital funds while lending for the purpose of property development/financing must not exceed 30% of a bank's deposits in Singapore (or 60% with the approval of the MAS).

5. Loan Concentrations and Country Risk

Loans to a single customer must not in total exceed 60% (or 100% with MAS approval) of the lending bank's capital. This provision is subject to a number of statutory exemptions which may be extended by the MAS at its discretion. The loan limit does not apply to country risk exposure involving several borrowers from the same country, although the MAS is beginning to monitor the country exposure of local banks on a consolidated basis. No limits on such exposure have as yet been imposed while foreign-owned banks are excluded from the monitoring process.

6. Foreign Currency Exposure

Although the MAS monitors the volume of banks' foreign currency trading, no exposure limits are imposed and regular prudential returns on foreign currency positions have recently been discontinued as part of the deregulation process. Spot checks on foreign currency exposure are undertaken during the course of bank examinations.

7. Bank Examination

On-site bank examinations by the MAS inspectorate (currently five in number) are undertaken on an occasional rather than a regular basis. The foreign establishments of local banks are not at present inspected and foreign supervisors are not permitted to inspect foreign-owned banks in Singapore. Bank secrecy laws prevent the communication to foreign supervisors of information relating to foreign-owned banks in Singapore.

8. Deposit Insurance

Singapore has no deposit insurance scheme although as a matter of record there have been no bank failures or deposit losses since the MAS was established in 1970.

9. Lender of Last Resort and Protective Arrangements

Routine liquidity assistance is provided to banks by the discount houses which in turn may look to the MAS for any funding shortfall. While preferring to exercise its lender of last resort function through the discount houses, the MAS does have broad statutory powers in this area. In particular, under a 1972 amendment to the Monetary Authority of Singapore Act the MAS "may, if it thinks such action is necessary to safeguard monetary stability, make a loan or advance to a bank carrying on business under the Banking Act or to such financial institutions or class of financial institutions as the Authority may from time to time approve against such forms of security as the Authority may consider sufficient".

Considerable importance is attached to letters of comfort as an additional safeguard for foreign-owned banks, while stand-by lines of credit are also encouraged. Finally, local branches of foreign banks are subject to separate liquidation proceedings in which branch depositors have prior claim to branch assets.

K. Switzerland

The Federal Banking Commission (FBC), which is independent of both the National Bank and the Federal Council, is charged with the supervision of the Swiss banking system. The National Bank's statutory functions are of a non-prudential nature although as a matter of practice it has maintained an active interest in this area. The FBC's supervisory activities are governed firstly by the Federal Law Relating to Banks and Savings Banks which dates back to the 1930s, and secondly by an Implementing Ordinance that has been periodically up-dated. Proposals for a new Banking Law are currently in the early stages of discussion but legislative action is probably several years away.

All banks having their residence in Switzerland are subject to the Banking Law, whether or not their business is conducted there. The Law applies equally to institutions conducting a banking business in Switzerland wherever their residence may be.

1. Entry Controls

In order to receive a licence from the FBC banks must meet certain statutory conditions. These include: (1) an organizational structure that ensures effective supervision of the management; (2) a minimum capital of SF2 million; and (3) a management of sound reputation. Foreign-controlled banks are subject to supplementary requirements including reciprocal treatment of Swiss-controlled banks in their country of origin. Any institution has a right to obtain a licence once the statutory conditions have been satisfied.

2. *Capital Adequacy*

The reguations affecting capital adequacy (which apply equally to Swiss branches of foreign banks) have recently been amended. The new guidelines (1) shift the basis for calculating required capital ratios from outstanding liabilities to various categories of asset; (2) allow banks limited use of subordinated loans to meet capital requirements; (3) introduce new rules for banks' investments in non-banking assets; and (4) direct that consolidated accounts be used to assess capital needs.

Under this scheme required capital ratios are graduated according to the presumed riskiness of different types of asset, as illustrated by specifications of 6-8% for domestic advances, an additional 1.5 percentage point premium for foreign assets, 30% for property investment (20% for bank premises) and 40% for non-bank affiliates. Certain contingent liabilities are also subject to capital requirements, as are forward transactions in currencies, precious metals and securities (0.3%) and open positions in foreign currency (10%) and precious metals (20%). The ratios are guidelines rather than strict limits and may be varied by the FBC in special cases. They do not apply to fiduciary deposits (invested at the customers' risk but in the name of the Swiss bank receiving the deposit) although the National Bank has drawn attention to the fact that such deposits may involve risks both for the customer vis-a-vis the Swiss bank and for the Swiss bank vis-a-vis the ultimate borrower.

Capital is defined to include paid-in capital, published and undisclosed reserves and (a new addition) subordinated loans having at least seven years to maturity up to a maximum of 10% of total capital. As from January, 1982 Swiss banks can no longer cover losses from unpublished reserves without revealing this in their profit-and-loss accounts.

3. *Liquidity Control*

Banks must maintain an adequate balance of liquid and marketable assets in relation to short-term liabilities.

Liquid assets are defined as cash holdings and balances on giro and postal checking accounts, while marketable assets include bonds and bills that can be pledged/discounted at the National Bank, overdrafts secured by such assets, inter-bank deposits maturing within one month, gold, bonds issued by sovereign borrowers and prime banker's acceptances maturing within three months. Short-term liabilities comprise all liabilities maturing within one month, sight deposits and 15% of savings deposits.

Short-term liabilities must be backed in some measure by liquid assets and in a greater measure by liquid plus marketable assets. The extent of this required backing increases as the proportion of short-term liabilities in the balance sheet rises so that, for instance, the marginal liquid asset backing jumps from 6% to 36% as short-term liabilities rise from 0·15% to over 35% of total liabilities. Liquid and marketable assets together must in any event amount to at least 6% of total liabilities. This approach to liquidity assessment is designed to place some formal limit on banks' maturity mis-matching, while also ensuring a minimum cushion of realizeable assets.

4. *Permissible Business Activities*

There are no formal restrictions on the kinds of business that banks may undertake, and in practice Swiss banks are universal rather than specialized. The public sector, represented by 30 cantonal banks and 45 banks belonging to districts and communities, has nevertheless tended in the past to attract the bulk of savings deposits.

5. *Loan Concentrations and Country Risk*

Loans to individual borrowers, measured as a proportion of the lending bank's capital, are subject to guidelines of 20% for unsecured loans and 40% for secured loans, with additional variations for inter-bank lending and loans to Swiss public bodies. The limits are now calculated on a consolidated basis and if exceeded must be reported to the FBC which may demand that the loans be reduced. On the other hand these restrictions do not apply directly to country risk where several borrowing entities from the same country may be involved.

The new solvency requirements (above) take some account of country of risk by specifying a 1.5 percentage point premium for foreign assets. In addition the FBC has recently issued a circular requiring auditors to include in their reports to the Commission a description of each bank's approach to country risk evaluation. The purpose of this requirement, however, is limited to ensuring that bank management is alert to the problem of measuring country risk, and no attempt is made by the FBC to form an independent view of particular countries' financial prospects.

6. *Foreign Exchange Exposure*

There are no specific limits on foreign exchange exposure other than the 10% incremental capital requirement for open currency positions (above). However, strong emphasis is placed by the FBC on the adequacy of internal control procedures.

7. *Bank Examination*

The FBC does not undertake on-site examinations of banks in the normal course of its supervisory duties. Instead, reliance is placed on independent bank auditors who have a special status under Swiss law. Such auditors are appointed and paid for by the banks but are licensed by the FBC for whom in effect they are required to act as agents. Auditors must ensure that all legal violations are promptly corrected or else reported to the FBC which must also be immediately informed of irregularities or losses that might jeopardize the security of depositors. The auditors' reports to the FBC (in contrast to shareholders' reports) must also reveal banks' true profits before adjustments to the inner reserves. Parent supervisors are not permitted to inspect foreign banks in Switzerland while their access to information is also limited by the Swiss bank secrecy laws.

8. *Deposit Insurance*

Switzerland does not yet possess a deposit insurance scheme, partly because central and other public sector banks have until recently attracted the major share of savings and other deposits from the general public. However, with the public's deposits being dispersed more widely among commercial banks proposals for such a scheme have been drafted by an expert committee and are now being considered in the context of broader banking reforms. The proposed system is mandatory, except for foreign banks having equivalent coverage from home-based schemes, and would be subject to a deposit ceiling equivalent to US $35,000. Protection would also be graduated so that only the first $10,000 would be fully covered, with a progressively increasing proportion of the loss born thereafter by the depositor. The introduction of any such scheme will have to await passage of the proposed new Banking Law which may take several years.

9. *Lender of Last Resort*

The National Bank law enumerates the Swiss National Bank's powers quite specifically but makes no reference to the lender of last resort function. On the other hand, this function may be viewed as an extension of the collateralized lending that the National Bank is authorized to undertake for monetary policy purposes. In any event the National Bank confirmed its preparedness to act as lender of last resort when in April, 1977, it participated in a line of credit offered to Credit Suisse in the wake of the Chiasso Affair.

L. United Kingdom

The Banking Act of 1979, which for the first time provides a statutory basis for banking supervision within the UK, was drafted in response to the secondary banking crisis of 1973/74 and the harmonization requirements of the 1977 EEC Banking Directive. The Act imposes on the Bank of England primary responsibility for regulating and supervising deposit-taking business and for this purpose establishes two categories of institution: recognized banks and licensed deposit-takers. This two-tier system (which is not required by the EEC Directive) enables the Bank to maintain its traditional approach to the supervision of recognized banks based on direct contacts with management, while adopting more formal regulatory procedures in relation to licensed deposit takers.

1. Entry Controls

The statutory requirements for recognition as a bank by the Bank of England are more stringent than those for obtaining a deposit-taking license. The main criteria are: (1) adequacy of financial resources (including a minimum capital requirement); (2) high reputation and standing in the financial community; (3) provision of a specified range of financial services; and (4) a management of integrity and prudence commanding appropriate professional skills. UK subsidiaries of foreign banks apply for recognition (or a license) in their own right, although the reputation criterion attaches to their parent institutions. In contrast, UK branches of foreign banks must apply in their parent banks' name and for this purpose the Bank of England has statutory power to delegate assessment of the bank's management and financial soundness (though not reputation) to the parent supervisory authority. Furthermore, whereas the capital and other solvency criteria apply in the normal way to UK subsidiaries of foreign banks they are applied to the whole parent organization in the case of branches, there being no formal requirement as to branch capital.

2. Capital Adequacy

The Bank of England does not seek to apply a capital adequacy norm to all or any class of banks. However, it has devised two capital ratios which, after taking into account the particular circumstances of each institution, are used as a basis for assessing capital adequacy. The Bank's approach is to take account of a banking group's consolidated worldwide operations in assessing capital needs, although UK subsidiaries of foreign banks are expected to be adequately capitalized in their own right.

The gearing ratio relates the capital base (with a deduction for premises) to all other non-capital liabilities apart from contingent liabilities. The purpose of this ratio is to ensure that a bank's capital position is regarded as acceptable by its depositors and other creditors. The second and more important calculation is the risk asset ratio which tests the adequacy of capital in relation to the risk of losses that may be sustained. For this purpose various classes of asset are weighted according to their supposed susceptibility to credit, investment and forced sale risk, commercial advances being taken as a benchmark and therefore accorded a uniform weighting of unity. The risk asset ratio is calculated by multiplying each balance sheet asset by its weight to produce an adjusted total of risk assets which is then related to the capital base. The capital base is defined to include share capital and reserves, subordinated debt with a minimum five years maturity up to a maximum of one third of total capital, and general bad debt provisions.

3. *Liquidity Control*

The Bank of England is still in the process of formulating its approach to the assessment of liquidity. However, in recent discussion papers it has developed a number of principles which are likely to be included in its final proposals. Most importantly, liquidity assessment should take account not merely of 'funding risk', that is the risk of not having available sufficient cash to meet obligations falling due on a particular day, but also the "interest-rate mismatch risk" whereby a bank engaging in maturity transformation may suffer losses as a result of movements in interest rates. Accordingly the Bank proposes to establish for each institution an estimate of liquidity needs made up of two components: (1) a proportion of its gross maturity-uncertain liabilities together with (2) a proportion of any net liability position arising from its maturity-certain liabilities and assets in a range of time-bands. Marketable assets would be placed at the start of the maturity ladder rather than according to their maturity date, although such assets would be subject to a discount where there is a credit, investment or forced sale risk. However, as with capital adequacy it is not intended that banks should conform to any standardized ratio.

The Bank of England recognizes that banks' international operations can lead to special problems in their liquidity management. Firstly, impediments on movements into or out of particular currencies may necessitate careful matching of maturity positions in those currencies. Secondly, banks may at times have to incur very high costs in order to obtain liquidity in a particular currency, because of their lack of direct access to the lender of last resort in that currency. However, it is not yet clear how overseas branches and subsidiaries of UK banks and UK branches and subsidiaries of overseas banks will be assessed for liquidity.

4. *Permissible Business Activities*

There are no specific controls on the types of business banks may engage in. However, the Bank of England would wish to ensure that any development of a bank's business could be accommodated comfortably within its managerial and financial resources.

5. *Country Risk*

Country exposure is monitored on a fully consolidated basis. For this purpose banks submit reports every six months detailing their claims on non-residents of the United Kingdom by borrower, country of borrower and maturity, with supplementary information on risk transfers (by guarantee) to third countries. Exposure to particular countries is then related to each bank's capital base and also aggregated in order to assess the overall exposure of the UK banking system. The Bank of England itself forms an independent judgement about the risks of lending to particular countries, using a three-fold classification based on the likelihood of debt servicing difficulties. However, there are no formal limits or norms for country exposure.

6. *Foreign Exchange Exposure*

The Bank of England's monitoring of foreign exchange risk is based on a distinction between 'structural' and 'dealing' positions in foreign currency. Structural exposure arising from a bank's fixed and long-term assets and liabilities is not subject to guidelines although it is included in the aggregate foreign currency position for purposes of capital adequacy assessment. In contrast, dealing positions reflecting day-to-day operations are subject to specific guidelines agreed individually with institutions. These guidelines are adapted to the particular circumstances and expertise of each bank but for those experienced in foreign exchange the limits would generally be: 10% of capital base for net dealing positions in any one currency and 15% of capital base for the aggregate net dealing position in all currencies taken together.

The Bank does not apply separate guidelines to UK branches of foreign banks where the branches' own internal controls (those exercised by its head office) and the monitoring arrangements of its own supervisory authority are considered satisfactory. On the other hand foreign branches (though not foreign subsidiaries) of UK banks are included in the Bank's guideline arrangements.

7. *Bank Examination*

There is no system of direct on-site examination of banks by the Bank of England and no regular assessment of the quality of a bank's loan portfolio (though details of large loans must be provided). The starting point for supervision is analysis of the relevant statistics which then provides the basis for interviews with senior management. These interviews are the cornerstone of the Bank's supervisory system, the prime aim being to build up over time an intimate picture of each institution and to assess the capabilities of management to control the business and fulfill its objectives. Branches of overseas banks undergo less comprehensive supervision because of the reliance placed on the parent bank's supervisory authority.

8. *Deposit Insurance*

The UK Banking Act provides for the introduction of a mandatory deposit insurance scheme which came into effect in February 1982. Under the new arrangements, 75% of a depositor's 'protected deposit' is insured, a protected deposit for this purpose being limited to £10,000 per institution. Inter-bank and foreign currency deposits are excluded from the scheme, as are certificates of deposit, secured deposits and deposits with a maturity of over five years. Protection does not extend to sterling deposits made with an institution's branches or subsidiaries outside the United Kingdom, while UK offices of overseas banks may be exempted from participation if their sterling deposit liabilities are already as well protected as they would be under the UK scheme. A deposit protection fund is to be established which will be funded from flat rate contributions by participant banks, calculated on the basis of their sterling deposits (subject to a maximum and minimum contribution that will tend to favor larger institutions). The initial fund will be £5-6 million, with power to borrow up to £10 million.

9. *Lender of Last Resort*

The Bank of England has a broad discretion to assist banks experiencing liquidity difficulties and/or threatened with insolvency. During and in the immediate aftermath of the UK secondary banking crisis of 1973/74 this discretion was exercised in a variety of forms which included unilateral support arrangements, joint support operations with the clearing banks, the guaranteeing of a troubled bank's loan portfolio, the acquisition of another problematical loan portfolio and the acquisition of one institution as a subsidiary of the Bank.

The Bank's view is that its lender of last resort function extends to the foreign network of parent banks under its jurisdiction and that, similarly, UK branches and subsidiaries of overseas banks are, for this purpose, the responsibility of the parent institution's supervisory authority. At the same time the Bank seeks non-legally binding undertakings ("comfort letters") from shareholders of those UK banks which are overseas controlled to the effect that they acknowledge a responsibility extending beyond strict legal liability to support their UK bank affiliates.

M. United States

The structure of the US banking system reflects various statutory limitations (now under Congressional review) on geographic and functional diversification. In particular the effective prohibition of inter-state banking has led to a highly fragmented system comprising some 15,000 banks, while limitations on the kind of business banks may undertake has resulted in financial specialization between commercial, savings and investment banks. At the same time, the supervisory process has been considerably complicated by a dual banking structure dividing regulatory responsibilities between state and Federal authorities, as well as by the co-existence of three federal agencies concerned with the supervision of commercial banks.

In essence, the office of the Comptroller of the Currency (OCC) supervises banks with national charters (including federally licensed branches of foreign banks); the Federal Reserve Board (FRB) and the states supervise state-chartered, Federal Reserve member banks; the Federal Deposit Insurance Corporation (FDIC) and the states supervise state-chartered, insured, non-member banks (including insured state branches of foreign banks); and the states alone supervise state-chartered, non-member, uninsured banks.

1. *Entry Controls*

National banks are chartered by the OCC while state banks are chartered by the various state authorities. In considering charter applications, state and federal authorities apply similar criteria, including: (1) the bank's future earnings prospects; (2) the general character of the proposed management; (3) the adequacy of its proposed capital structure; and (4) the convenience to and needs of the community to be served.

Foreign banks seeking to establish branches, agencies or subsidiaries under state or federal license are subject to the same chartering criteria and procedures as domestic banks. The establishment of foreign branches and subsidiaries of domestic banks is subject to approval by the FRB (or the FDIC in the case of State non-member banks).

2. *Capital Adequacy*

In addition to being considered at the chartering stage, capital adequacy is also monitored regularly as part of the bank examination process. For this purpose federal agencies rate capital in relation to: (1) the volume of risk assets; (2) the volume of inferior quality assets; (3) bank growth experience, plans and prospects; and (4) the strength of management. Furthermore, earnings trends and dividend pay-out ratios are examined in order to assess the prospective contribution of retained earnings to capital growth.

The OCC and the FRB have recently introduced common guidelines to be used in assessing capital adequacy which distinguish between primary and secondary capital. Primary capital consists of common and perpetual preferred stock, surplus and undivided profits, contingency and other capital reserves, mandatory convertible instruments and 100% of the allowances for possible loan losses. Secondary capital consists of limited-life preferred stock and subordinated notes and debentures; it can amount to no more than 50% of primary capital; and the secondary instruments must be phased out of the bank's capital beginning in the fifth year prior to maturity. Under these guidelines regional and smaller banks are subject to specified capital norms but multinational banks will continue to be assessed on an individual basis with a view to raising their capital ratios, in due course, closer to those of the smaller banks.

The FDIC has issued its own separate statement of policy on capital which excludes all subordinated debt from the evaluation process. This difference of approach reflects in part the FDIC's concern to protect depositors by ensuring the viability of banks as going concerns rather than by paying off depositors with failed banks.

Capital is evaluated by federal agencies on a worldwide consolidated basis. In the case of foreign joint ventures, account is taken of the possibility that financial support going beyond the initial investment by the US bank might be needed while consideration is also given to the fact that foreign branches and subsidiaries of US banks may be permitted to engage in riskier activities than their parent institutions. US subsidiaries of foreign banks are assessed for capital in the normal way, while federally licensed branches of foreign banks are required to hold at a member bank deposits or investment securities equal in value to 5% of their liabilities. These branch "capital equivalency deposits" (which may also be required by state authorities for state licensed branches) are intended to ensure competitive equality by substituting for the capital required of national banks.

3. *Liquidity Control*

Liquidity is considered during the bank examination process although, no attempt is made to impose liquidity norms by means of published ratios. The federal agencies rate liquidity with respect to: (a) the volatility of deposits; (b) reliance on interest-sensitive funds and frequency and level of borrowings; (c) technical competence relative to structure of liabilities; (d) availability of assets readily convertible into cash; and (e) access to money markets or other ready sources of cash. The liquidity position is considered on a worldwide consolidated basis, although certain bank functions may be analyzed separately.

4. *Permissible Business Activities*

In general, commercial banks in the United States are confined to the business of commercial banking. They may not underwrite securities or engage in other securities-related activities or in commercial activities unrelated to banking, and they are subject to a variety of statutory restrictions on, for instance, real estate lending, permissible investment securities and the holding of corporate stocks. Since 1978, US branches and agencies (as well as subsidiaries) of foreign banks have been subject to parallel restrictions on their activities in the United States.

On the other hand the FRB, which regulates the foreign activities of most US banking organizations, permits foreign branches and subsidiaries of US banks to engage in a wider range of activities than would be allowed domestically so as to enable them to compete more equally with banks in the host country.

In recent years the strict separation of banking and non-banking activities in the US has been eroded, a fact which may soon be given legislative recognition as a result of deregulation proposals now before Congress.

5. *Country Risk*

Country risk is monitored and controlled in several ways. Firstly, exposure to country risk is measured on a world-wide consolidated basis by means of a semi-annual reporting system. This embraces cross-border and non-local currency loans to foreign borrowers adjusted for third country guarantees. Secondly, national banks are subject to a 10% of capital limit on loans to individual borrowers, a constraint now interpreted to apply to different public sector borrowing entities from the same country where there is a common source of repayment. Thirdly, bank examiners assess each bank's system for evaluating country risk and its procedures for establishing country lending limits. Fourthly, loans to particular countries may, in extreme cases, be adversely classified either as 'substandard', where an interruption in debt servicing has occurred or is imminent, 'doubtful', where interest has been due and unpaid for an extended period, or 'loss' where there is little or no prospect of repayment. Finally, in less extreme cases, exposure to a particular country may be 'listed' or subject to comment in the examination report where the amount lent, measured as a percentage of capital, exceeds a specified prudent limit.

In order to co-ordinate their approach to country risk, the federal regulators have established an Inter-agency Country Exposure Review Committee which meets three times each year and votes either to classify loans to a particular country or to designate countries as strong, moderately strong or weak. The country designation determines the prudent exposure limit relative to capital, and therefore provides a basis for listing loans. This threshold is set at 25% for strong countries, 10% for moderately strong countries and 5% for weak countries. Listed exposures to weak and moderately strong countries may also be subject to special comment.

Five key ratios (among other critieria) are used to determine whether a country should be designated as strong, moderately strong or weak. These are:

1. The current account balance in the most recent year as a percentage of total exports of goods and services in that year.
2. The cumulative current account deficit in the three most recent years as a percentage of average annual export earnings during those years.
3. The net interest payments on external debt in the most recent year as a percentage of average annual export receipts during the three most recent years.
4. Net interest payments as a percentage of international reserves in the most recent period.
5. The total current debt-service requirements as a percentage of exports of goods and services.

6. *Foreign Exchange Exposure*

The regulatory authorities do not lay down any specific limits or guidelines for foreign exchange exposure. However, they do monitor individual bank positions through a reporting system requiring weekly exposure returns in nine currencies and monthly breakdowns of foreign currency positions by maturity. The main focus of regulation is on banks' procedures for limiting foreign exchange risk and for this purpose the Uniform Guideline on Internal Control of Foreign Exchange in Commercial Banks sets out minimum standards for policy documentation, internal accounting controls and audit documentation.

7. *Bank Examination*

Regular bank examinations by the authorities' own examiners lie at the heart of the US supervisory process. Federal on-site examinations focus on (1) Capital adequacy; (2) Asset quality; (3) Management quality; (4) Earnings and profitability; and (5) Liquidity. This uniform rating system (known as "CAMEL") is used to arrive at an overall composit rating which identifies, on a scale of one to five, those banks which are in sound condition and those with weaknesses requiring closer supervisory attention. The examination process is buttressed by remote computer-based systems designed to monitor the condition of banks between examinations and to serve as an early warning system to detect potential weaknesses. The present emphasis is on strengthening these systems, so as to reduce the need for frequent, on-site examinations.

Federal examiners also conduct on-site examinations of foreign branches and, local laws permitting, foreign subsidiaries of US banks. US branches and subsidiaries of foreign banks are examined in the normal way although in these cases the Federal Reserve imposes extensive reporting requirements relating to the parent banks' structure and condition on the grounds that a parent bank's acitvities may affect the soundness of its foreign branches and subsidiaries.

8. *Deposit Insurance*

With the exception of three states, deposit insurance through the FDIC is a prerequisite to receiving a bank charter. US branches of foreign banks accepting retail deposits must also be insured, in which case, as a condition of insurance, the branch must pledge assets to the FDIC equal to 10% of total liabilities, representing security against any country or additional prudential risk beyond the US authorities' control. International Banking Facilities are not insured and foreign branches of US banks are currently outside the FDIC scheme. Insurance coverage is confined to non-bank deposits of residents and non-residents in any currency up to a ceiling of $100,000 per deposit. As a matter of practice the FDIC has preferred to use its powers to arrange assisted mergers for failing banks rather than to force closure and pay off insured depositors. One result of this policy is that uninsured deposits (now accounting for around one third of the total) have been effectively protected, with

99.9% of all depositors recovering the full amount of their deposits in failed banks during the period 1934 through 1980.

The FDIC is funded by member banks and currently manages an insurance fund of $12 billion, equivalent to over 1% of insured deposits, with authority to borrow up to $3 billion from the Treasury.

9. *Lender of Last Resort*

The Federal Reserve has statutory lending powers to discount eligible paper or make advances secured by satisfactory collateral. Such facilities are open to any bank which maintains reserves with the Federal Reserve, including the US branches, agencies or subsidiaries of foreign banks. The Federal Reserve may also provide indirect liquidity assistance to foreign establishments of US banks by channelling credit through the US parent/head office. The following kinds of support may be offered:

a. **Short-term adjustment credit.** This is available on a short-term basis to meet temporary requirements for funds or to cushion more persistent fund outflows pending an orderly adjustment of the borrowers' assets and liabilities. Credit under this heading is generally charged at the basic discount rate, although a variable surcharge may be applied to large, frequent borrowers.

b. **Extended seasonal credit.** This is available for longer periods to provide seasonal credit to smaller institutions lacking ready access to national money markets. Credit is generally charged at the basic discount rate.

c. **Other extended credit.** This may be provided to banks experiencing difficulties arising from exceptional circumstances or practices involving only that institution, if such assistance is in the public interest and the needed funds are not available from other sources. Such credit may also be provided where liquidity strains are affecting a broad range of institutions. A special rate above the basic discount rate may be charged.

d. **Emergency credit for others.** In unusual circumstances, individuals, partnerships and non-financial corporations may obtain emergency credit from the Federal Reserve if failure to obtain such credit would adversely affect the economy.

The Federal Reserve's lender of last resort function is designed to provide temporary liquidity to solvent institutions. Power to deal with insolvency is in the hands of the FDIC which has three main options in such emergencies. Firstly, it may pay off the depositors of a failed bank although this is not the preferred route given possible adverse confidence effects. Secondly, it may invite existing banks to bid to assume the deposit liabilities of the failed bank and to purchase certain of its assets, including the goodwill (the 'purchase and assumption' option). And, finally, it may provide direct financial assistance to a bank which is in danger of closing. At present this last capital infusion option can be exercised only when the troubled bank is essential to its community, but the FDIC is seeking a statutory amendment which would remove the essentiality test and focus instead on situations where severe financial conditions are threatening the stability of a significant number of insured banks.

N. Observation Ratios Adopted by the EEC Advisory Banking Committee

The first EEC Banking Co-ordination Directive of 1977 provides, inter alia, for the establishment of "ratios between the various assets and/or liabilities of credit institutions with a view to monitoring their solvency and liquidity." Initially such ratios are to be used for observation purposes only, although the Directive evidently envisages the possibility that harmonized prudential ratios might be applied in the longer term. In 1980 the EEC Advisory Banking Committee began to define a number of observation ratios which are now being calculated on a trial basis for a sample of banks within each Member State.

The Advisory Committee currently employs three solvency ratios (a risk assets ratio, a gearing ratio and a large exposures ratio) as well as a profitability ratio and a liquidity ratio. These ratios embrace the activities of banks' foreign (and domestic) branches but because consolidated supervision has reached varying stages among different member states, there is no uniform approach to consolidation in the ratio calculations.

For the purposes of the solvency ratios capital is defined to include paid-up equity capital, reserves (hidden and published) and provisions with the character of reserves. However, because national practices with respect to subordinated debt vary, each solvency ratio is calculated twice, both including and excluding subordinated debt as allowable capital. Investments amounting to 20% or more of the share capital of bank affiliates are deducted so as to avoid double-counting capital that may be used as a basis for gearing both by the investing bank and the affiliate.

1. Risk Assets Ratio

The risk assets ratio is defined as the ratio of capital to risk assets. The Advisory Committee has also devised rules for weighting risk assets according both to the nature and country of origin of borrowers. Thus borrowers are classified as governments (central and local), banks and private non-bank entities, while countries of origin are divided into a preferential zone, comprising all EEC countries plus other industrial countries, and a residual non-preferential zone. Claims on banks are classified by country of operation in the case of subsidiaries and by country of incorporation of the head office in the case of branches. The following weightings are applied:

a. **zero:** claims on or guaranteed by either preferential zone governments or specified international organizations.

b. **20 percent:** claims on or guaranteed by preferential zone banks, and contingent liabilities incurred on behalf of such banks.

c. **100 percent:** claims on non-preferential zone governments and banks, all claims on private non-bank borrowers, and contingent liabilities incurred on behalf of such entities. Fixed assets (comprising premises, other property, equipment and investments in non-bank affiliates) also come within this weighting category.

2. *Gearing Ratio*

This is defined as the ratio of capital to other liabilities, where "other liabilities" consist of all non-capital liabilities including acceptances and other contingent liabilities. Fiduciary accounts are excluded from the calculation.

3. *Large Exposures Ratio*

This is defined as the ratio of total large exposures to capital. A "large exposure" is the total of all commitments to a single borrower exceeding the following percentages of the lending bank's capital:

a. 20% in the case of exposures to private non-bank borrowers and non-preferential zone governments and banks.

b. 100% in the case of exposures to preferential zone banks.

Commitments to preferential zone governments and to specified international organizations are excluded from the large exposures definition. The Advisory Committee has accepted the desirability of grouping claims on different borrowers who may be legally or otherwise linked but is at present prevented by data deficiencies from adopting this approach.

4. *Profitability Ratio*

This ratio, which is also used in assessing solvency, has been calculated both as the ratio of gross profit to total assets and as the ratio of net profit to capital.

5. *Liquidity Ratio*

The first experimental liquidity ratio has been defined as the ratio of liquid assets to short-term liabilities. For this purpose liquid assets comprise notes and coin, gold, balances with the central bank, postal check accounts, inter-bank balances at call or notice of up to three months, assets rediscountable or eligible as collateral at the central bank, other money market instruments whose negotiability is considered by the supervisory authorities to be beyond doubt, and quoted debt securities. Short-term liabilities comprise all domestic and foreign currency liabilities of up to three months maturity, including all sight, term and savings deposits. Although the Advisory Committee favors the use of remaining rather than original maturity in calculating the maturities of assets and liabilities, it has not proved possible to standardize this practice.

Publications

Policy Statement:

The Problem of Exchange Rates
The Group of Thirty

Study Group Reports:

Toward a Less Unstable International Monetary System
The Reserve Assets Study Group

Foreign Exchange Markets Under Floating Rates
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The Group of Thirty
Two World Trade Center
Suite 9630
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Group of Thirty

The Group of Thirty was established in December 1978, to explore basic problems in the functioning of the international economic system. It meets twice a year, for two to three days at a time. Between these meetings, study groups and researchers gather material to serve as a basis for the Group's discussions.

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Group of Thirty

The International Monetary Fund and the Private Markets

H.J. Witteveen

Geoffrey Bell
Otmar Emminger
John Heimann
Alexandre Lamfalussy

C.W. McMahon
Robert Pringle
Robert V. Roosa
Robert Solomon

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The International Monetary Fund and the Private Markets

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Preface

This paper has grown out of the general work of the Group of Thirty on the international monetary system, and especially out of that of its committee on international banking. Accordingly, it is issued in all the names of all the members of the Group's Steering Committee (excepting Prof. Peter B. Kenen) and of two members of the banking committee that have taken a particular interest in this project—Dr. Otmar Emminger and Mr. John Heimann.

Robert Pringle
March, 1983

The International Monetary Fund and the Private Markets

The Case for an Early Approach to the Markets

This study suggests that the International Monetary Fund may soon need to borrow from private financial markets for the first time, to obtain supplementary bridging finance until new resources are made available under the recent agreements to enlarge general quota subscriptions and the General Arrangements to Borrow. It would be prudent for members of the Fund to encourage its staff to actively pursue preparations for the possibility of market borrowing. Certainly, the IMF should not wait until it faces a dire shortage of funds. Indeed, an early approach to the markets for relatively small sums might facilitate the rapid mobilization of market finance on a larger scale in case of sudden need.

Because member country legislatures need to approve the recently agreed increases in quota subscriptions and the GAB, those new resources would become available to the IMF only by late 1983 at the earliest and, more likely, only during 1984. Nor can there be confidence about the volume of the new resources thus made available until the all-important approval of the United States Congress has been obtained.

After allowing for undrawn commitments of about SDR 16 billion, or roughly $17.7 billion, including assistance arranged recently for Mexico, Argentina, Chile, and Brazil, the IMF can count only about SDR 8 billion, equivalent to roughly $9 billion, available for new lending (see Table 5, page 41). On that basis, given the probable further needs of member countries, we estimate that the Fund might need to borrow up to the equivalent of about $9 billion to supplement its resources in the next twelve months.*

Estimates of the resources available to the IMF for new lending are always subject to some uncertainty, partly because some of its currency holdings may be unavailable for new lending when the countries issuing the currencies concerned face constraints on their balances of payments. Estimates of possible borrowing needs are likewise subject to uncertainty, because fresh demands on the Fund cannot be foreseen with assurance. That is especially true at the present juncture when the fall in world oil prices may oblige more large oil-exporting countries to seek IMF assistance, while at the same time reducing the chronic surpluses of some other oil exporters, notably Saudi Arabia, on which the IMF has relied for supplementary borrowed resources in the past.

Quota subscriptions of the Fund's member countries have always been the basic sources of its funds, although it has periodically supplemented its resources since 1962 by borrowing from member countries and Switzerland (which is not a member, but cooperates closely and actively). In January, 1982, the IMF's Executive Board confirmed that quotas should continue to be the main source of funds, while recognizing that borrowing provides an important source of temporary, supplementary resources**.

Although the IMF has never yet borrowed from the markets, its Articles of Agreement give it authority to borrow from any source and in the currency of any member country provided only that it obtains the consent of the government of the member country in whose currency it proposes to borrow***. (Thus the Fund cannot borrow Swiss francs as Switzerland is not a member; Switzerland, however, has lent money to the Fund in currencies other than its own).

At the beginning of 1981 the IMF did, indeed, publicly raise the possibility of a first approach to the markets. In the event, it was able to supplement its resources by further borrowing from member countries, but the possibility of market borrowing at some point has been kept open. The need for it may arise in a more acute form in the near future for several reasons. First, at a time when several leading countries are in payments deficit and when the financial markets remain under strain, further applications for IMF assistance can be expected; second, there is uncertainty about the amounts and timing of supplementary resources the IMF may be able to borrow from member countries, including the persistent surplus oil exporters on which it has relied in the past; third, negotiations of arrangements to borrow from member countries have not always been quick.

---

*IMF accounts are denominated in Special Drawing Rights but, for convenience, their dollar equivalents are expressed here at the conversion rate of approximately SDR 1 = $1.1, applying in February, 1983.

**Executive Board Decision 7040—(82/7), 13 January, 1982. see page 45.

***Article VII, Section 1.

The argument that it would be prudent for the IMF to make active preparations for the possibility of an early approach to the markets is not based on a short-term view alone. It is based also on the belief that it would be in the interest of the IMF, its member countries and the financial system to open the fullest range of options available to it for an unpredictable longer term. The attitudes of member countries to the IMF have changed in the past and could change again.

There is wide recognition that the policies followed by member countries as a condition of access to IMF assistance are more important than the sums which the IMF actually lends and that observance of those conditions by borrowing countries will, of itself, improve a country's economic performance and re-attract private capital. On that score it can be argued, and was by some member countries until the summer of 1982, that an enhanced role for the IMF did not necessarily depend on any substantial increase of its resources.

However, the latest move to speed the provision of new resources to the IMF is a material expression of the belief that they are important for member countries to make a more effective contribution toward adjustment. Such conditional assistance helps countries in payments difficulties, including those that have interrupted full debt service, to restore their creditworthiness and thus their ability to attract capital flows.

It can be argued that the case for keeping a wide range of options open has been reinforced by another development. The financing provided by the commercial banking system to complement recent IMF assistance complementary financing for other countries has provided concrete evidence of the new importance attached to a closer cooperative approach by the IMF, its members and the banking system. In one sense, complementary bank financing can be viewed as an alternative to IMF borrowing in the markets as a means of increasing the total funds made available to facilitate economic adjustment. However, that still leaves the argument that the IMF needs to put up money of its own to attract complementary financing including, if necessary, periodic bridging finance borrowed by the IMF from the markets.

IMF Resources and Commitments

The IMF has augmented the general resources provided by the quota subscriptions since 1962, when the General Arrangements to Borrow came into being. Under the GAB, additional resources are made available to the Fund by the Group of Ten leading industrial countries* plus Switzerland. These and other arrangments to borrow additional resources from member countries are described on pages 17-19 and pages 27-29.

But the Fund cannot rely with assurance on an adequate flow of borrowed funds from surplus countries. Some commitments from official entities to lend to the Fund, including GAB participants, may not be usable when the Fund would like to call the loan because of weakness in the balance of payments position of the lender. In addition, in the event of a balance of payments need, an official lender to the Fund can request immediate repayment.

The urgency of the IMF's need is thrown into relief in Table 5 (page 41). We estimate that at the present time (March, 1983) the IMF's quota resources usable for lending** (consisting mainly of SDR holdings, the currencies of industrial countries and of some oil exporters) amount to approximately SDR 15 billion ($16.5 billion), and agreed undisbursed lines of credit (excluding GAB) to about SDR 9 billion. Against this, the IMF's undisbursed commitments under stand-by and extended arrangements are estimated at about SDR 16 billion. We further estimate that some SDR 7 billion of this was due to be financed from the Fund's quota resources, reducing the amount still available from this source for new lending to SDR 8 billion. A further SDR 9 billion was due to be financed from borrowed resources, reducing total available to zero. (The undrawn GAB lines of credit totalled SDR 6 billion but it is clear that not all of these GAB lines of credit could be utilized at the same time and they are, at present, restricted to use by participants in the agreement).

Meanwhile, claims on the Fund have risen to high levels. Reserve positions in the Fund—which represent reserve assets of member countries that could be used if they experienced balance of payments difficulties—amount to about SDR 21 billion; and loan claims that are similarly liquid are about SDR 9 billion. It is improbable that all the members holding these liquid claims could be in balance of payments deficit at the same time. Thus it would not be expected that a large proportion of these claims would be encashed at any one time. However, they do represent a potential call on the Fund's resources in excess of its usable currency holdings and it is important that the Fund can assure their liquidity in the event of need.

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*United States, Japan, Germany, France, United Kingdom, Italy, the Netherlands, Belgium, Canada and Sweden.

**The concepts of "usable currencies" is described further on page 14.

The potential size of requests for Fund assistance in future months depends to a large extent on the action of members with large quotas—i.e. major industrial countries. Some of *these* countries have substantial balance of payments deficits. It is true that the role the Fund will be called upon to play in financing these deficits cannot be predicted with any degree of accuracy. However, in these circumstances of uncertainty, additional requests of very substantial Fund financing of payments deficits may be made before the increase in quotas becomes effective. This uncertainty may itself weaken the leverage the Fund needs to exert a constructive influence in situations that call for adjustment and restructuring.

Recent Developments

In January 1983, the Group of Ten leading industrial countries and Switzerland agreed to increase their commitments to provide periodical supplementary resources under the General Arrangements to Borrow from SDR 6.4 billion to SDR 17 billion (roughly from $6.7 to $18.7 billion). They agreed also that GAB resources would in future be available for relending by the IMF to all its members instead of, as hitherto, only to members of the G-10. Switerland, which had previously contributed to GAB financing without committing itself in advance to the sums it would contribute, is to become a participant in the GAB and has committed itself to provide a proportion of the enlarged GAB facility, namely 6 per cent, or about $1.1 billion.

In February 1983, the Interim Committee of 22 countries representing the full membership of the IMF agreed that the general quota subscriptions to the IMF should be increased by 47.5 per cent from SDR 61 billion to SDR 90 billion (from about $67 billion to $98.5 billion) under the eighth five-yearly review of IMF quotas.

However, amendment of the GAB requires acceptance by all the GAB countries, which in many countries requires legislation, and the quota increase must be approved by the Fund's Board of Governors with a majority of 85 per cent of the voting power. A member's quota cannot be increased until it has consented to the increase and paid the subscription in full. No increase in quotas becomes effective before the Fund determines that members having not less than 70 per cent of present quotas have consented to the increases proposed for them.

Some of the main assistance programs agreed between member countries and the IMF since the summer of 1982 and being negotiated at the time of writing, (February, 1983), are summarized in the table below, along with complementary financings agreed with commercial banks and others.

Major IMF Assistance and Complementary Financings Mid-1982 to February 1983

(billions of:)

	IMF Assistance		Complementary Financings by Commercial Banks	
Agreed	SDRs	$	SDRs	$
Mexico	3.6	4.0	5.0	5.5
Argentina	2.0	2.2	1.5	1.7
Chile	0.8	0.9	(possibly to be agreed)	
Under Negotiation				
Brazil	5.0	5.5	4.4	4.8
Uruguay	0.4	0.5	(possibly to be agreed)	
Total	12.0	13.0		

Borrowing Options and Implications

In approving financial markets the International Monetary Fund would have several options, but nearly all would have similar implications. (One of these is that market borrowing, like borrowing from member countries, would provide the IMF with resources, without at the same time increasing the potential demand for Fund assistance, as is the case when quotas are increased. However, the average cost of money to the Fund and therefore its members might be increased even more than it has been by borrowing from member countries, and a larger proportion of total resources might have to be obtained at floating rates of interest which would, in turn, increase the proportion of money lent by the Fund at floating interest rates; and a new element of foreign exchange risk would be introduced. In summary, market borrowing might entail a marginal increase in cost and in foreign exchange and interest rate uncertainty for the IMF and its member countries.)

In terms of the *denomination* of assets offered to investors, the IMF would seem to have the following main choices:

i) Assets denominated in *Special Drawing Rights* would carry no exchange rate risk for the IMF itself, but the appeal of such assets to the market would be limited by the fact that the composition of the SDR would meet the asset and liability matching requirements of only a limited part of the financial community. In the view of many bankers, there would need to be provisions for the option of immediate redemption or refinancing of SDR assets in the event of any changes in the SDR's composition. Investors would need assurance of liquidity.

ii) Alternatively, the IMF might wish to borrow simultaneously in the key financial centers the currencies constituting the SDR in proportion to their representation in the SDR "basket". This would have the advantage of establishing an IMF presence in several markets at the same time. But whether it sought access to the domestic or Euromarkets, the Fund would require the consent of the five issuing countries* which might pose difficulties for those in a weak balance of payments position.

iii) Because of the possible constraint mentioned above, the IMF might prefer to borrow in several key markets simultaneously, but not necessarily always in all the five issuing countries of SDR's currencies.

In our view, options (ii) or (iii) above would maximize the total that the Fund could raise in market finance at short notice.

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*Since January, 1981, the SDR is composed of US $0.54, DM 0.46, F 0.74, Y34 and 0.071, in pound sterling. The relative importance of these currencies in the value of the SDR is influenced by exchange rate fluctuations. For example, on January 25th, 1983, their shares were: US dollar 49.7 per cent; DM 17.3 per cent: the yen 13.1 per cent; sterling 10 per cent; and French franc 9.8 per cent.

A view presently held by some members of the Fund is that a continuous and even growing dependence on market financing would change the character of the Fund, as an institution of a cooperative nature that has always relied mainly on subscriptions from member countries, whose voting power in the Fund is closely linked to those subscriptions. It may be felt also that over time, large recourse to the markets by the Fund might come to be seen as an alternative to quota increases, which it cannot be, and weaken this cooperative character as well as the control of governments over its activities. Some official lenders may feel that the liquidity of their claims on the Fund might over time be reduced; while potential official borrowers as competitive. In our judgment, however, these concerns are misplaced, and are outweighed by the overriding requirement that the Fund should have, and be seen to have, adequate resources to strengthen the system at a time when it is under acute strain. Such concerns do not in any event apply to occasional or periodic recourse to the markets for bridging finance.

Market Approach

An overwhelming majority of bankers polled by the Group of Thirty in 1981 said that they thought the Fund would be able to borrow "large amounts" on international financial markets, although several raised "technical" questions about the IMF's status and its lack of a "conventional balance sheet".*

At the short end of the market, such borrowing might include the acceptance of short-dated deposits from banks or lines of credit with banks in key financial centers (requiring appropriate legal arrangements). It would be possible for the IMF to issue, also, short-dated obligations, with characteristics similar to those of US commercial paper or Treasury Bills, on one or more of the domestic money markets of the countries represented in the SDR. In the United States, for example, the IMF could issue short-dated discount instruments which would be exempted from registration by the Securities and Exchange Commission (SEC), and which might be regarded by investors as similar in some respects to US government securities. In the other four countries, legal, tax or other obstacles to such issues are unlikely to be insuperable if the host governments consent to IMF borrowing of their currencies.

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*The question and a summary of the responses are reprinted at the end of this paper in Appendix II. The profile which the IMF might wish to present to investors is discussed in Appendix I.

However, as the maturity of Fund lending presently financed by borrowing is in the range of 3-7 years, and as the Fund prudently seeks to match the maturities of its lending and borrowing as closely as possible, it might be more suitable for it to seek *medium-to-longer term market finance*, even if the recourse to market finance was not expected to be repeated in future. Again, as the techniques of borrowing should fit the purposes for which the funds were sought, this would clearly be desirable if it was anticipated that the IMF might have recourse to the financial markets on a regular basis for supplementary financing. In either case, a wider range of borrowing options would come into consideration.

In the quest for medium and longer-term funds, the IMF would have the option of both the international bond and bank loan markets. Like other borrowers, its presence in one of those markets would strengthen its standing in both. In practice, however, the IMF might find it easiest to make its initial approach to the international bank loan market for several reasons.

The bank loan market

The international bank loan market is best described as the wholesale sector of the international capital market. As such, it is usually in a position to supply funds to most borrowers in larger amounts than the international bond markets. Moreover, the banks making up this market can be expected to have a readier understanding of the IMF's special status than the wider spectrum of investors in the international bond markets. Nor would the IMF be competing as closely here with borrowers like the World Bank and European Investment Bank, which have the advantage of being development banks with conventional balance sheets and which have established themselves firmly in international bond markets over many years.

The largest syndicated loan to date on the international bank loan market has been the $4 billion raised for the French Government in 1982. It is our view that the IMF could in this way raise substantial amounts denominated in US dollars, and also by assembling an SDR basket from the individual currencies. As the authorities of all the countries concerned would have to consent to Fund borrowing of their currencies, the IMF might consider going to the Euromarkets for some of the currencies and to the domestic markets for others, depending on market conditions.

The market success of the IMF's first commercial loan would be an important consideration, and hence it would be preferable for the first loan to be pitched at a size somewhat less than the maximum thought achievable. As regards the maturity of the loans, in present conditions, lenders might be most at ease with final maturities of five or seven years. If a maturity towards the longer end of this range or beyond it were sought, this might reduce the size of any such borrowing—though clearly the terms would depend on market conditions at the time.

Negotiable Instruments.

Alternatives or adjuncts to the syndicated bank loan market are the various markets for negotiable bonds and notes. In general, those markets provide some advantages over the loan market. Ultimate distribution is wider, as the spectrum of investors is broader. Moreover, the existence of a secondary market provides easy re-entry for additional borrowings at market-determined rates. In addition, the classical foreign bond markets offer scope for obtaining fixed-rate financing at maturities somewhat longer than available in the syndicated loan market. However, the principal disadvantage of the bond markets is the relatively smaller amounts which can be raised in them by most borrowers.

Again, the Fund might borrow either in SDR or in its constituent currencies. In general, the chief drawback of SDR-denominated bonds and notes, however priced, is their limited size (the largest begin an SDR 100 million floating rate offering by Ente Nationale per L'Energia Elettrica), though the IMF might be able to raise larger amounts than has normally been the case in the past.

Alternatively, the IMF might issue bonds or notes denominated in the five individual national currencies which comprise the SDR. As with the other borrowing options considered above, if one of the five currencies could not be borrowed, the Fund would have to accept the exchange risk, or consider other means of covering it (e.g. the Fund might effect swaps through lines with central banks). Under the current composition of the SDR, raising SDR 1 billion would require separate bond issues of the following magnitudes in each of the five component currencies:

$540 million
DM460 million
£71 million
FFr740 million
Y34,000 million

The amounts contained in the example above are fairly large compared with typical Eurobond offerings. However, a borrower of the

IMF's stature might issue such amounts. Additional flexibility might be provided by dividing each of the issues into two maturities, for example the equivalent of SDR 500 million 3-year and 7-year maturities.

An important additional benefit of this form of borrowing lies in the scope for obtaining fixed-rate financing in the individual currencies. All of the bond markets can provide such financing, though perhaps in smaller amounts than suggested above. The exception is the US dollar bond market, which could certainly accommodate $540 million of fixed-rate financing.

The five separate issues illustrated on the previous page could be executed in the Eurobond or the domestic markets. The Eurobond markets have the advantage that, particularly in the case of dollar financing, the documentation requirements are considerably less. However, as market conditions may change rapidly, many of these and other more technical issues should in our view be left for negotiation between the Fund and its creditors, and it is not sensible to attempt to prejudge the outcome.

The Options Summarized

The most important factor for the IMF when choosing amoung various borrowing options is the volume of money to be raised in a given period. This cannot be determined precisely in advance, since it will depend on a number of factors, including the date of effectiveness of increased quotas and the expansion of the GAB, the world economic situation and the number and size of countries requiring assistance. But it is evident that for substantial amounts, the syndicated loan market or large standby lines of credit with banks in the major centers would be the best. However, if it was considered that the Fund might need to have regular recourse to the markets, it would be appropriate for the IMF to consider eventually tapping every significant capital market open to it. This would be facilitated if, from an early stage, the IMF included some negotiable instruments in its liability structure.

Summary

The main points can be summarized as follows:

1) A need for supplementary bridging resources from the markets could arise before the recently agreed enlarged resources under quota subscriptions and the GAB become available to the IMF;

2) Members of the IMF should encourage the staff to continue active preparation for such a contingency, including, perhaps, an early entry into the markets for relatively small sums to pave the way for rapid mobilization of larger amounts in case of sudden need;

3) Initially, it might be advisable for the Fund to concentrate on the international bank loan market where funds are obtainable in larger amounts than on international bond markets and where the IMF's special status would be more readily understood by the professional banking community than it might be by the wider spectrum of investors in international bond markets;

4) However, in the event of continuous supplementary market financing, it might be in the IMF's interest to seek the widest possible spread of maturities, to offer investors a broad range of assets and to establish its presence in all sectors of the international capital market. In such circumstances, it might be in the IMF's interest to borrow not only in the world's key money markets for short and medium term funds, but also in the off-shore Eurobond and the classical foreign bond markets;

5) Market borrowing by the IMF would involve certain obstacles and costs, notably certain exchange and interest rate risks but such obstacles are surmountable. The precise techniques (or mix of techniques) should be decided in the light of market circumstances and the needs of the Fund. However, in present circumstances, where a sudden need for substantial supplementary resources might be experienced at a time when conventional sources of additional funds were not available on the required scale, we consider that the Fund should be authorized to approach the markets this year.

Appendix I

A Brief Explanation of the Fund's Operations, its Balance Sheet and Income Position

Membership and Resources

1. The Fund's membership comprises 146 countries and includes all the industrial market economies (except Switzerland) and most developing countries, as well as a number of centrally planned economies in Africa, Asia, and Europe. In addition to its regulatory and consultative role, the Fund provides temporary financing to members with balance of payments deficits by using the resources provided by members in strong balance of payments and international reserve positions. The Fund also supplements international liquidity, when the need arises, by allocating Special Drawing Rights (SDRs), an internationally created reserve asset, and supervises their use. In addition, the Fund administers, as trustee, two interest subsidy accounts to reduce the cost to eligible countries of certain forms of Fund assistance, and the winding-up of the Trust Fund established in 1976 to provide balance of payments assistance on concessional terms to developing countries.

2. Each member is assigned a quota, which reflects its relative importance in the world economy; quotas are reviewed at intervals of not more than 5 years. They determine a member's subscription to the Fund's resources, are the main basis for determining relative voting power, and are an important guide to the amount a member may borrow from the Fund if it has a need to finance a balance of payments deficit. The resources of the Fund consist primarily of these subscriptions which, as a rule, have to be paid 25 percent in international reserve assets—gold until 1978 and SDRs since then—and the remainder in the member's

own currency. However, the Fund may permit payment of the reserve asset subscription in currencies of other members or, exceptionally, in a member's own currency; in total, 20.5 percent of subscrptions have been paid with reserve assets and 79.5 percent with the member's currency. The Fund has supplemented its resources by borrowing when necessary to meet the needs of its members for balance of payments financing. Borrowing to date has been exclusively from official sources, but its statutes authorize the Fund from any sources, official or private, with the concurrence of the member whose currency is borrowed.

Financial Assistance

3. The Fund extends balance of payments assistance to members by providing usable foreign exchange or SDRs against payment of a member's own currency. On a quarterly basis, the Fund determines which members are in sufficiently strong balance of payments and reserve positions for their currencies to be usable for lending or for other payments by the Fund ("usable currencies"). A member indebted to the Fund whose position is judged sufficiently strong is expected to begin repaying outstanding loans in advance of the customary repayment period.

4. The Fund makes financial resources available to members under a range of policies and facilities.[1] These differ mainly in the type of balance of payments need they are intended to finance and in the associated adjustment effort required from member countries to qualify for assistance. The adjustment effort is intended to be sufficient for the borrowing member to overcome its balance of payments difficulties and to achieve a viable external position in the medium term. Under some facilities, drawings are phased, and the adequacy of the adherence to agreed policies are monitored by means of agreed performance criteria that must be met by the member in order to entitle it to make further drawings. The main financial terms of the various facilities in effect at present are shown Table 3 (page 33).

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[1] Members borrwing from the fund are said to make "purchases" (or "drawings") from the Fund, as the transaction takes the form of a purchase of the currencies of other members, or SDRs, against payment of an equivalent amount of the member's own currency. If the currency purchased is not a "freely usable" (i.e. reserve) currency, its issuer is obliged to convert the amount sold by the Fund into a "freely usable" currency; as a result, the purchasing member in fact receives a currency in which international settlements can be made. Upon maturity, members must buy back their currencies from the Fund using other currencies or SDRs, thereby making "repurchases," (i.e., repaying their borrowings).

5. Apart from borrowing under these facilities, calls on the Fund's resources can also be made by a member using its "reserve tranche position." A member's reserve tranche at any time represents the amount of reserve assets subscribed by the member plus the net amount of the member's currency that has been purchased by other members. It is measured by the excess of the member's quota over the Fund's holdings of its currency, excluding holdings that arise from the member's use of credit under tranche policies and the various special facilities. A member can draw on its reserve tranche positions at any time without policy conditions if it represents that it has a balance of payments need to do so. The reserve tranche position of any member with a balance of payments need therefore represents potentially an immediately callable claim on the Fund's resources. At the end of October, 1982, total reserve tranche positions amounted to SDR 16.7 billion (Table 1, page 30).

The Fund's Balance Sheet

6. The Fund's balance sheet at October 31, 1982 is reproduced on page 21. It shows assets of SDR 70.4 billion, comprising mainly currency holdings of SDR 61.0 billion,[1] holdings of SDRs amounting to SDR 4.7 billion, gold (valued at the former official price of SDR 35 an ounce) of SDR 3.6 billion,[2] and other assets. The Fund's accounts, together with all operations, are denominated in SDRs,[3] and members are obliged to maintain the SDR value of the Fund's holdings of their currencies except for holdings in the Borrowed Resources Suspense Accounts.[4] Currency holdings are derived mainly from subscriptions and from drawings on the Fund; the amount of currencies reflecting use of the individual Fund facilities are given in the Explanatory Notes (Note 4).[5] The Fund's holdings of SDRs derive from the payment of SDRs of subscriptions, repurchases, and charges; the Fund does not receive allocations of SDRs

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[1] Members are entitled to substitute for their currency non-negotiable, non-interest bearing securities which are encashable on demand by the Fund.

[2] Valued at the market price on October 31, 1982 the Fund's gold holdings of 103.4 million ounces amounted to SDR 41.2 billion.

[3] The SDR is a basket of five major currencies, the value of which is determined daily by summing the values in U.S. dollars, based on market exchange rates, of the specified amounts of the five currencies (US$ 0.54, DM 0.46, F 0.74, Y 34, UKL 0.071).

[4] Borrowed Resources Suspense Accounts are used only for temporary holding of borrowed resources pending their disbursement or repayment.

[5] As mentioned, a member borrowing from the Fund provides its own currency as instrument of indebtedenss. Fund lending therefore does not reduce the overall total of the Fund's holdings of currencies and SDRs, although it does change the composition of those assets; if financed from borrowed resources, drawings raise the Fund's currency holdings concurrently with its liabilities. A supplementary presentation of accounts (Table 1, page 30) classifies currency holdings by source for the period 1978-1982.

which are made only to Fund members that participate in the SDR department. The Fund may use SDRs not only to provide assistance to members, but also to acquire currencies the Fund needs—e.g. for the repayment of the Fund's own borrowing, or directly to service its debts under some agreements. The gold holdings derive from the various payments to the Fund that formerly had to be made in gold; the Fund's gold may be sold, by a decision approved by a majority of 85 percent of the voting power in the Executive Board, and the proceeds used for a variety of purposes, including the discharge of the Fund's obligations. (The Fund may no longer buy gold but can accept payments from a member in gold at market-related prices, if it so decides with an 85 percent majority of voting power.)

7. The liability side of the Fund's balance sheet includes subscriptions, which constitute the Fund's paid-in quotas amounting to SDR 61.1 billion at October 31, 1982, accumulated reserves of SDR 0.9 billion, borrowing amounting to SDR 7.5 billion, and other liabilities.[1] Subsumed in the subscriptions but not shown separately in the balance sheet are members' reserve positions which, as discussed, represent potentially an immediately callable demand on the Fund's resources.[2]

Revolving Character of Fund Resources

8. An important feature of the Fund's assets is the short-to-medium-term maturity of its assistance to members. Loans are repayable after a grace period in quarterly or semi-annual installments; these are to be made between the third and fifth year after the drawing for all loans financed from the Fund's own resources except extended facility loans, which are repaid between the fourth and tenth years. Supplementary finance and enlarged access drawings, which are financed from borrowed resources, are repayable beginning 3½ years and ending 7 years after the drawing. These repayment terms indicate the maximum maturities of Fund loans, as members are entitled to make repayments at any time, and expected to

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[1] Any member may withdraw from the Fund at any time by written notice, and withdrawal becomes effective upon receipt of such a notice. Settlement of accounts between the Fund and a withdrawing member is to occur with reasonable dispatch, but no payment may be made until six months after the date of withdrawal. The Fund may not be liquidated except by a decision of the Board of Governors requiring a majority of votes cast, but the Executive Board may temporarily suspend all operations and transactions if it decides that liquidation of the Fund may be necessary. If the Fund goes into liquidation within six months of a member's withdrawal, the accounts between the Fund and the member shall be settled in accordance with the provisions governing liquidation of the Fund.

[2] Reserve positions in the Fund are shown in the supplementary presentation of accounts (Table 1, page 30).

make early repayments as and when their balance of payments and reserve positions improve. This repayment pattern strengthens the Fund's liquidity position and its ability to assist other members whose balance of payments and reserve positions are deteriorating.

9. While its statutes allow the Fund to stretch repayment that would result in exceptional hardship for a member by rescheduling obligations beyond the maximum maturity period associated with the facility under which a drawing was made, the Fund has not used this authority. However, within the normal limits of access to its resources, the Fund in a number of instances has made financial support available under a new arrangement to a member undertaking adjustment policies when balance of payment problems proved to be of a more persistent nature than could be solved in the framework of one stand-by or extended arrangement.

Fund Borrowing

10. Over the years, the Fund has entered into a number of borrowing arrangements to supplement the resources available from quota subscriptions. In 1962, the Fund and ten major industrial countries that constitute the Group of Ten[1] entered into the General Arrangements to Borrow (GAB), which permit the Fund to borrow from this group of countries to finance purchases from the Fund by any of them. The GAB were originally concluded for a period of four years but have been periodically renewed and at present total SDR 6.4 billion.[2] One of the purposes of the GAB is to ensure that the Fund is able to meet requests for support from members with large quotas while safeguarding its ability to assist other members. The total of undrawn lines of credit under the GAB is currently SDR 5.7 billion; however, the Fund cannot borrow the whole of this amount at any one time since it would not borrow the currency of the participant for whose benefit the GAB is activated.

11. The Fund's other borrowing arrangements have been of a temporary character and financed special lending facilities of the Fund. The two oil facilities, now almost repaid, involved Fund borrowing amounting to a total of SDR 6.9 billion in 1974-76 from 17 countries and institutions. The supplementary financing facility, established in 1979, is financed by

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[1] Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. In addition, Switzerland has made resources available on some occasions of GAB activation.

[2] Agreement has been reached among participants to increase the GAB to SDR 17 billion and, in specified circumstances to make GAB resources available to finance drawings by nonparticipants. Switzerland will become a participant in the enlarged GAB.

bilateral loan agreements between the Fund and 14 countries or institutions totaling SDR 7.8 billion. Most recently, in order to finance loans to members under the policy of enlarged access, the Fund concluded an agreement with the Saudi Arabian Monetary Agency (SAMA) to borrow up to SDR 8 billion, as well as agreements with the BIS and the central banks under which 18 countries or institutions are making available a total of SDR 1.3 billion.

12. Loan claims on the Fund held by member countries or their agencies are encashable on demand if the member represents that it has a need because of current and prospective balance of payments developments and changes in reserve holdings. Under these conditions the Fund is committed to repay its borrowing upon demand, or to arrange for the purchase of the claim by another member. Repayment is made out of the Fund's general resources and *all the Fund's assets are available to meet its obligations in accordance with its statutes, Rules and decisions.* An additional means of liquidity not affecting Fund resources was incorporated in recent loan agreements which allow the lender to request promissory notes in bearer form to the extent of its claims on the Fund; such notes would be transferable to official or private parties. In contrast to loan claims, promissory notes are not encashable by the holder in advance of scheduled maturity.

13. For potential private lenders to the Fund, particular interest may attach to the mechanism for the solution of disputes incorporated in the borrowing agreement with the SAMA. The agreement contains a procedure of arbitration for questions of respective rights and obligations arising between the Fund and SAMA.[1] Moreover, as mentioned, SAMA is entitled at any time to request the Fund to provide bearer notes for outstanding loans. Notes issued under these provisions are governed by New York law and, with respect to such notes, the Fund agreed to waive its immunity from judicial process and to submit to the jurisdiction of the courts of New York, England, or of the Canton of Geneva in Switzerland.

14. As of end-October 1982, outstanding borrowings by the Fund totalled SDR 7.5 billiion; undrawn lines of credit under the GAB were SDR 5.7 billion and under the supplementary facility and enlarged access policy SDR 10.5 billion. The initial maturity of the bulk of the Fund's borrowing is in the range 3½-7 years, corresponding to the maturity of the

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[1] See, e.g., para 18 of the Borrowing Agreement with the Saudi Arabian Monetary Agency, reproduced in *Annual Report 1981*, p. 172ff.

Fund's lending financed with borrowed resources; exceptions to this general rule of matching the maturity of borrowing and loans are the short-term credit loans from the BIS and central banks of SDR 1.3 billion, which have initial maturities of up to 2 years.

Fund Liquidity and Borrowing Guidelines

15. The Fund's Executive Board regularly reviews the Fund's liquidity position and financing requirements. In this context, it has established Guidelines for Borrowing (reproduced below, page 35), which state that the Fund will not allow the total of outstanding borrowing by the Fund plus unused credit lines extended to the Fund to exceed the range of 50 to 60 percent of the total of Fund quotas. Because of their special nature, only one half of unused GAB lines of credit—or the total of outstanding GAB borrowing, if this is greater—are included in this total. In the event that outstanding borrowing and unused credit lines reach 50 percent of quotas, the Executive Board will assess the various technical factors that determine, at that time, the availability of unused lines of credit; while this assessment is carried out, the ratio would not be allowed to exceed 60 percent. These considerations are subject to review by Executive Directors in case of major developments; they will at any rate be reviewed, and adjusted as appropriate, when the Eighth General Review of Quotas has been completed. On October 31, 1982, total outstanding borrowing and unused credit lines, calculated in accordance with these Guidelines, were equal to 33.5 percent of quotas of SDR 61.1 billion.

The Fund's Income Position

16. The most important determinants of the Fund's net income position are the volume of use of Fund resources in the reserve tranche and the credit tranches, the rate of charge on use of Fund resources, the rate of interest on the SDR, and the rate of remuneration paid by the Fund to members whose currencies have been used in loans. The Fund's income position and its major determinants are shown in Table 2 (page 32) for the financial years 1978-82. At October 31, 1982, the Fund's reserves amounted to SDR 939 million. In order to achieve appropriate increases in the Fund's reserves, the Executive Board has established the target of realizing net income each year equivalent to three percent of the Fund's reserves at the end of the previous year.

The Fund's financial position is reviewed at the beginning of each financial year, and the rate of interest charge on lending to members financed from the Fund's own resources and the rate of remuneration may be adjusted on the basis of the estimated income and expense of the Fund during the coming year and the target amount of income for the year. The income position is also reviewed at mid-year and the rate of interest on lending to members and the rate of remuneration adjusted as may be necessary. For the year commencing May 1, 1982, the rate of interest on use of the Fund's own resources was set at 6.6 percent and the rate of remuneration continued at 85 percent of the interest rate on the SDR.[1] The difference between the rate of renumeration the Fund pays on the currencies it uses and the rate of interest it receives, which is lower, is made possible by the Fund's holding of interest-free resources derived primarily from net sales of gold received as reserve asset subscription and from reserves. Charges on the use of borrowed resources under the Fund's current policy are set of semi-annually and reflect the interest cost to the Fund of borrowing plus a margin of 0.2 percent.

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[1] The interest rate on the SDR is set quarterly and is equal to the weighted average of the market yield on three-month U.S. Treasury bills, the three-month interbank deposit rate in Germany, three-month interest money rate against private paper in France, the discount rate on two-month (private) bills in Japan, and the market yield for three-month U.K. Treasury bills. At October 31, 1982, the SDR rate of interest was 8.90 percent.

GENERAL DEPARTMENT

(Note 1)

BALANCE SHEET

as at October 31, 1982

(Amounts expressed in special drawing rights)

(Note 2)

Assets	
Currencies and Securities (Notes 3 and 4)	61,032,295,743
Special Drawing Rights	4,673,293,406
Gold with Depositories (Note 2)	3,620,396,120
Borrowed Resources Held in Suspense (Note 1)	281,946,232
Charges Receivable (Note 4)	186,305,452
Accrued Charges (Note 4)	262,544,160
Other Assets (Note 2)	295,986,699
Total Assets	70,352,767,812
Capital, Reserves and Liabilities	
Capital	
Subscriptions of Members	61,059,800,000
Reserves (Note 6)	938,508,810
Liabilities	
Borrowing (Note 5)	7,537,756,897
Accrued Remuneration (Note 4)	509,409,243
Interest Payable	13,133,015
Accrued Interest	263,911,041
Other Liabilities	30,248,806
Total Capital, Reserves and Liabilities	70,352,767,812

The accompanying notes are an integral part of the financial statements.

GENERAL DEPARTMENT

(Note 1)

STATEMENT OF RESERVES

as at October 31, 1982

Amounts expressed in special drawing rights

(Note 2)

Special Reserve	
Balance, April 30, 1982	569,740,289
General Reserve	
Balance, April 30, 1982	365,579,703
Net Income for the Six Months Ended October 31, 1982	3,188,818
Total Reserves and Net Income	938,508,810

The accompanying notes are an integral part of the financial statements.

GENERAL DEPARTMENT
NOTES TO THE FINANCIAL STATEMENTS

1. General Department

Under the Articles of Agreement, the General Department consists of the General Resources Account, the Special Disbursement Account and the Investment Account. The Investment Account was not operative at October 31, 1982. The General Department also includes Borrowed Resources Suspense Accounts which have been established by the Executive Board in order to hold and invest currencies borrowed before these can be used in a transaction or operation or received in repurchases before repayments to lenders can be made.

General Resources Account

Assets held in the General Resources Account comprise gold, currencies of the Fund's member countries, and special drawing rights (SDRs). The Fund's resources in the General Resources Account are made available to members in accordance with the Fund's policies either in the form of currencies or SDRs which members purchase against the payment of their own currencies. The amount of such use is related to a member's quota in the Fund.

In addition to purchases under the Fund's regular facilities, members may use the Fund's resources under decisions on Compensatory Financing (to assist members, particularly primary exporters, encountering payments difficulties produced by temporary shortfalls attributable to circumstances beyond their control and members encountering payments difficulties produced by an excess in the cost of their cereal imports) and Buffer Stock Financing (to assist members in connection with the financing of international buffer stocks of primary products), the Extended Fund Facility (to provide medium-term assistance to members to make structural adjustments in their economies), and the Supplementary Financing Facility and the Policy on Enlarged Access (to assist members facing serious payments imbalances that are large in relation to their quotas). Members were also able to use the Oil Facility (for balance of payments problems caused by increases in the cost of petroleum and petroleum products). Use of the Fund's resources is dependent on members having a balance of payments need.

Gold transactions, receipt of SDRs in payment of charges, repurchases by members, and use of SDRs by the Fund take place through the General Resources Accounts

Borrowed Resources Suspense Account

Resources of the Borrowed Resources Suspense Accounts, which became operational in May 1981, derive from currencies of the Fund's member countries borrowed under arrangements between the Fund and certain of its members or institutions within their territories, the Bank for International Settlements and the Swiss National Bank. Members are not obligated to maintain the SDR value of their currencies held by the Fund in the Borrowed Resources Suspense Accounts, and their SDR value is covered mainly by investments in SDR denominated obligations.

At October 31, 1982 borrowed resources held in suspense were as follows:

SDR 281,946,232

Special Disbursement Account

The Special Disbursement Account was activated on June 30, 1981. The Fund, as Trustee, decided that the Trust Fund shall be terminated as of April 30, 1981. Under the relevant decision, resources received by the Trust Fund subsequent to the termination date are to be transferred to the Special Disbursement Account, the first SDR 750 million of which are to be transferred to the Supplementary Financing Facility Subsidy Account. At October 31, 1982 SDR 25,734,435 has been received into the Special Disbursement Account from the Trust Fund and transferrd to the Supplementary Financing Facility Subsidy Account. There were no resources held in the Special Disbursement Account at October 31, 1982.

2. Accounting Practices

Unit of Account

The accounts of the General Resources Account are expressed in terms of the SDR, the currency value of which is determined by the Fund. Members' currencies and securities are valued in terms of the SDR on the basis of representative rates of exchange determined in accordance with decisions of the Executive Board. Gold with depositories is valued on the basis that one unit of special drawing rights is equivalent to 0.888671 gram of fine gold.

Property, Furniture and Equipment

The established policy of the Fund is to charge as an expense of each accounting period the total costs incurred for fixed property, furniture and equipment.

Income and Expense

The Fund maintains its books of accounts on an accrual basis and, accordingly, recognizes income as it is earned and records expenses as they are incurred. It is the practice of the Fund to make all calculations on the basis of the exact number of days in the accounting period.

3. Currencies and Securities

Each member has the option to substitute nonnegotiable and noninterest-bearing securities for that amount of the member's currency held by the Fund which is in excess of one-quarter of 1 per cent of the member's quota.

A currency held by the Fund is revalued whenever that currency is used by the Fund in a transaction with another member, or for such other purposes as the Fund may decide. All currency holdings are revalued as at April 30 each year. Whenever the Fund revalues its holdings of a member's currency, an account receivable or an account payable is established for the amount of currency payable by or to the member in order to maintain the value of the currency in terms of the SDR. The balances of the accounts receivable or payable are reflected in the Fund's currency holdings. At October 31, 1982 accounts receivable amounted to SDR 1,505,197,356 and accounts payable amounted to SDR 723,144,588. Members are not obligated to maintain the SDR value of their currencies held by the Fund in Borrowed Resources Suspense Accounts.

4. Operational Transactions

For the six months ended October 31, 1982, members' purchases amounted to SDR 2,790 million of which SDR 203 million was the reserve tranche, SDR 754 million was under the Fund's regular policies, SDR 765 million was under Compensatory Financing, SDR 111 million was under the Buffer Stock Financing, and SDR 957 million was under the Extended Fund Facility. Of the total purchases, SDR 857 million was financed under the Supplementary Financing Facility and SDR 156 million under Enlarged Access Resources. Over the same period, repurchases by members totaled SDR 770 million. Purchases in the reserve tranche made after April 1, 1978 are not subject to repurchase.

At October 31, 1982 outstanding purchases of members were as follows (in millions of SDRs):

Reserve Tranche	6
Regular Facilities	3,332
Compensatory Financing	4,181
Buffer Stock Financing	111
Extended Fund Facility	2,620
Oil Facility	216
Supplementary Financing Facility:	
Under stand-by arrangements	3,443
Under extended arrangements	1,525
Enlarged Access Resources:	
Under stand-by arrangements	482
Under extended arrangements	835
Total	16,751

The Fund levies charges on its holdings of a member's currency to the extent that the holdings (i) have been acquired under the policy that has been the subject of an exclusion, or (ii) exceed the member's quota after deducting holdings that are the subject of an exclusion. Remuneration is paid on the amounts by which 75 per cent of a member's quota on April 1, 1978, adjusted for increases or decreases in the member's quota after that date, exceeds the Fund's holdings of the member's currency after deducting amounts that are the subject of an exclusion. At October 31, 1982 the total holdings on which the Fund levies charges amounted to SDR 16,698 million and the total creditor postions on which the Fund pays remuneration amounted to SDR 10,748 million.

Members incur certain obligations to the Fund with the use of Fund resources from the General Resources Account. One member, Democratic Kampuchea, has not fulfilled its financial obligations to repurchase a part of the Fund's holdings of the member's currency, to pay charges on currency balances held by the Fund and to submit information on monetary reserves. At October 31, 1982, unpaid charges receivable from

Democratic Kampuchea amounted to SDR 5,329,440 and are included in the balance sheet as charges receivable and as a deferred credit. On December 19, 1978 the Executive Board decided that Democratic Kampuchea may not make use of the general resources of the Fund until such time as Democratic Kampuchea is fulfilling it obligations under the Articles of Agreement to which Article XXVI, Section 2(a) applies.

5. Borrowing

Outstanding borrowing by the Fund at October 31, 1982 was as follows:

Oil Facility	SDR 196,882,361
Supplementary Financing Facility	4,968,583,722
Enlarged Access Resources	1,595,036,814
General Arrangements to Borrow	777,254,000
	SDR 7,537,756,897

Oil Facility

The Fund entered into borrowing agreements with various members and Switzerland, or institutions within their territories, under which these lenders agreed to provide the Fund with specified currencies to finance purchases of currencies from the Fund by other members under the Oil Facility. The outstanding borrowings carry interest rates of 7 per cent for amounts called under the 1974 borrowing agreements and 7¼ per cent for amounts called under the 1975 borrowing agreements. Any calls made by the Fund under these agreements are repayable in installments beginning not later than 3½ years, to be completed not later than 7 years, after the date of the calls.

Supplementary Financing Facility (SFF)

The Supplementary Financing Facility entered into force on February 23, 1979. The Fund has entered into borrowing agreements with 14 members, or institutions within their territories, and with the Swiss National Bank under which the lenders have agreed to make resources available to the Fund, at call, up to SDR 7.784 billion over the next four years to finance purchases by members under this Facility. Interest paid by the Fund on amounts borrowed under the borrowing agreements is based on the average yield on U.S. Government securities with a constant maturity of five years.

Enlarged Access Resources (EAR)

The Fund has entered into borrowing agreements with various members, or institutions within their territories, the Bank for International Settlements and the Swiss National Bank under which the lenders have agreed to make resources available to the Fund, up to SDR 9.305 billion, to finance purchases by members under the Fund's policy on Enlarged Access. The maturities of borrowing by the Fund under these agreements vary from six months to seven years. Interest paid by the Fund on amounts borrowed under these agreements is at variable rates, which are established periodically, and are related to market interest rates.

General Arrangements to Borrow (GAB)

Ten members, or institutions within their territories, have adhered to the General Arrangements to Borrow under which the Fund may borrow their currencies up to specified amounts when supplementary resources are needed to forestall or cope with an impairment of the international monetary system. These arrangements first became effective from October 24, 1962 and have been renewed until October 23, 1985. The Swiss Confederation has been associated with the GAB since June 1964. The present arrangement with the Swiss Confederation expires on July 15, 1985. The Fund pays a transfer charge of one-half of one per cent on amounts borrowed under these arrangements, and, in addtion, pays interest at the rates at which the Fund levies charges on the holdings of currencies resulting from purchases for which it incurred the indebtedness, provided that the rate of interest shall be not less than 4 per cent per annum on any part of the indebtedness. Any calls made by the Fund under the GAB are repayable within five years.

The interest rate being paid by the Fund on indebtedness under the General Arrangements to Borrow was 4 per cent per annum.

The Fund has established guidelines for borrowing, which provide that the Fund will not allow the total of outstanding borrowing plus unused credit lines to exceed the range of 50 to 60 per cent of the total of Fund quotas. The total shall include, in respect of the GAB, either outstanding borrowing by the Fund under the GAB or one-half of the total credit lines under the GAB, whichever is the greater. On October 31, 1982 total outstanding borrowing and unused credit lines, calculated in accordance with these guidelines, were equal to 33.5 per cent of quotas.

6. Reserves

The Fund determines annually what part of its net income shall be placed to the General Reserve or to the Special Reserve, and what part, if any, shall be distributed. The Fund may use the Special Reserve for any purpose for which it may use the General Reserve, except distribution.

Income from investments in U.S. Government securities was placed to the Special Reserve from November 1, 1957 until February 15, 1972 when the investment program was terminated. A decision by the Executive Board provides that any administrative deficit for any financial year must be written off first against this Reserve.

7. Other Compensations and Benefits

The Fund pays various allowances to or on behalf of executive directors and staff including the employer's contribution to the Staff Retirement Plan. All contributions to the Plan and all other assets, liabilities and income of the Plan are held separately and can be used or incurred only for the benefit of the participants in the Plan and their beneficiaries. The funding of the Plan is based upon a percentage of a national gross salary, and the employer contributes that part of the costs and expenses of the Plan not provided by the contributions of the participants.

Experience gains and losses of the Plan, as determined by the actuary engaged by the Pension Committee, are amortized over a period of 15 years. The unamortized experience losses at October 31, 1982 amounted to SDR 56.4 million (calculated at the SDR value of the U.S. dollar on that date). Payments over the next 15 years to amortize the actuarial experience losses are estimated to be approximately SDR 76.6 million (at the October 31, 1982 SDR/US$ rate).

Table 1. Balance Sheet[1]

(In millions of SDRs)

	Financial Years Ended April 30					Six Months Ended October 31.
Assets	1978	1979	1980	1981	1982	1982
Currency holdings representing:						
Outstanding purchases[2]						
Regular facilities	3,420	2,316	2,293	2,630	3,263	3,332
Compensatory Financing	2,668	2,945	2,873	2,617	3,634	4,181
Buffer Stock Financing	—	48	74	—	—	111
Extended Fund Facility	175	407	504	980	2,159	2,620
Oil Facility	6,313	4,240	2,494	1,581	565	216
Supplementary Financing Facility	—	—	502	2,018	4,112	4,968
Enlarged Access resources	—	—	—	—	1,161	1,317
Total Outstanding Purchases	12,576	9,956	8,740	9,826	14,903	16,745
Other currency holdings	22,780	29,611	29,931	46,199	44,958	44,287
Gold[3]	4,507	4,055	3,636	3,620	3,620	3,620
Special Drawing Rights	1,371	1,290	1,407	5,445	5,456	4,673
Other Assets	6,327	169	143	196	633	1,028
Total Assets	47,471	45,081	43,857	65,286	69,570	70,353
Liabilities, Resources and Capital						
Reserve tranche positions						
Unremunerated	5,009	4,537	4,987	6,312	5,991	5,979
Remunerated	4,016	3,773	3,393	6,813	9,626	10,748
Total Reserve Tranche Positions	9,025	8,310	8,380	13,125	15,617	16,727
Borrowing[4]						
General Arrangements to Borrow	1,730	777	777	777	777	777
Oil Facility	6,329	4,257	2,474	1,528	526	197
Supplementary Financing Facility	—	—	502	2,018	4,112	4,969
Enlarged Access resources	—	—	—	—	1,358	1,595
	8,059	5,034	3,753	4,323	6,773	7,538
Other Liabilities	6,353	276	324	514	1,177	816
Reserves	713	760	763	843	935	939
Balance of subscribed capital	23,321	30,701	30,637	46,481	45,068	44,333
Total Liabilities, Reserves and Capital	47,471	45,081	43,857	65,286	69,570	70,353

See Page 31 for Table 1. Balance Sheet Notes.

Table 1. Balance Sheet Notes

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[1] These financial statements should be read in conjunction with the audited financial statements and related notes.

[2] As discussed in the text, to obtain Fund resources, a member uses its own currency to purchase an equivalent amount of currencies of other members or SDRs. Approved and undisbursed amounts available for purchase an equivalent amount of currencies of other members or SDRs. Approved and undisbursed amounts available for purchase by members under stand-by and extended arrangements as at April 30, were as follows.

(In millions of SDRs)

	1978	1979	1980	1981	1982	Oct. 31, 1982
Undisbursed balances of stand-by and extended arrangements	3,639	1,378	2,108	8,056	11,155	8,387

[3] Gold with depositories is valued on the basis of SDR 35 per fine ounce. As at April 30, the market value of the Fund's gold, based upon the London afternoon fixing price, was as follows:

(In millions of SDRs)

1978	1979	1980	1981	1982	Oct. 31, 1982
17,945	22,328	41,563	41,662	33,078	41,211

[4] Undrawn lines of credit as at April 30, were as follows:

(In million of SDRs)

	1978	1979	1980	1981	1982	Oct. 31, 1982
General Arrangements to Borrow	5,023	5,784	5,734	5,764	5,675	5,656
Supplementary Financing Facility	—	7,784	7,282	5,766	3,672	2,587
Enlarged Access resources	—	—	—	—	7,947	7,410

Table 2. Income, Expense, Net Income and Reserves Financial Years 1978-1982

(*In millions of SDRs*)

	Financial Years Ended April 30				
Operational Income					
Periodic charges	786.6	678.1	519.4	592.7	1,092.1
Interest on SDR holdings	39.8	57.1	81.8	265.8	657.2
Other	13.2	18.1	13.0	23.8	39.6
Total	839.6	753.3	614.2	882.3	1,788.9
Operational Expenses					
Remuneration	200.9	171.7	241.0	372.8	908.6
Interest	537.1	458.1	284.0	329.5	634.9
Other	3.6	3.9	—	—	—
Total	741.6	633.7	525.0	702.3	1,543.5
Net Operational Income	98.0	119.6	89.2	180.0	245.4
Administrative Expense	70.5	73.5	86.1	99.9	153.4
Net Income	27.5	46.1	3.1	80.1	92.0
Reserves:					
Special Reserve - beginning of year	320.9	348.4	394.5	397.6	477.7
- end of year	348.4	394.5	397.6	477.7	569.7
General Reserve	365.6	365.6	365.6	365.6	365.6
Total Reserves	714.0	760.1	763.2	843.3	935.3

Details may not add to totals due to rounding.

Table 3. Financial Terms of Fund Facilities as at October 31, 1982

	Interest Charge[1] (Per Cent)	Repayment Period[2] (Years)	Financed from
First credit tranche	6.6	3 - 5	Owned Resources
Higher credit tranches	6.6	3 - 5	
Extended Fund facility	6.6	4 - 10	
Compensatory financing facility	6.6	3 - 5	
Buffer stock financing facility	6.6	3 - 5	
Supplementary financing facility	12.075	3.5 - 7	Borrowed Resources
Enlarged access policy	12.55	3.5 - 7	

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[1] Charges on loans under the supplementary financing facility and enlarged access resources are adjusted semi-annually on the basis of the Fund's cost of borrowing. Charges on other facilities are fixed but may be adjusted following a review of charges, as discussed below. Use of Fund credit in addition is subject to a service charge of 0.5 per cent.

[2] Repayments are to be made in quarterly installments over the period specified, and for other loans (loans under the extended facility, the supplementary financing facility, and the enlarged access policy) in semi-annual installments.

INTERNATIONAL MONETARY FUND
Guidelines for Borrowing by the Fund
Executive Board Decision—January 13, 1982

Quota subscriptions are and should remain the basic source of the Fund's financing. However, borrowing by the Fund provides an important temporary supplement to its resources. In present circumstances, it facilitates the provision of balance of payments assistance to its members under the Fund's policies of supplementary financing and enlarged access.

The confidence of present and potential creditors in the Fund will depend not only on the prudence and soundness of its financial policies but also on the effective performance of its various responsibilities, including, in particular, its success in prompting adjustment.

Against this background the Executive Board approves the following guidelines on borrowing by the fund.

1. Fund borrowing shall remain subject to a process of continuous monitoring by the Executive Board in the light of the above considerations. For this purpose, the Executive Board will regularly review the Fund's liquidity and financial position, taking into account all relevant factors of quantitative and qualitative nature.

2. Subject to paragraph 4 below, the Fund will not allow the total of outstanding borrowing plus unused credit lines to exceed the range of 50-60 per cent of the total of Fund quotas. If the total of outstanding borrowing plus unused credit lines reaches the level of 50 per cent of quotas, the Executive Board shall assess the various technical factors that

determine, at that time, the availability of balances of unused lines of credit. While this assessment is being made, the total of outstanding borrowing plus unused credit lines may rise, if necessary, beyond 50 per cent, but shall not exceed 60 per cent of total quotas.

3. Recognizing that the credit lines of all participants in the General Arrangements to Borrow (GAB) cannot be used at the same time and that the GAB can be activated only to finance purchases by a GAB participant, the total of outstanding borrowing plus unused credit lines under paragraph 2 above shall include, in respect of the GAB, either outstanding borrowing by the Fund under the GAB or one-half of the total of credit lines under the GAB, whichever is the greater.

4. In the case of major developments, the Executive Board shall promptly review, and may adjust, the guidelines. In any event, the guidelines shall be reviewed when the Board of Governors has completed the Eighth General Review of Quotas, and may be adjusted as a result of that review of the guidelines.

5. The percentage limits specified in paragraph 2 above, or any other limits that may be adopted as a result of a review pursuant to paragraph 4 above, are not to be understood, at any time, as targets for borrowing by the Fund.

Appendix II

Question and summary of answers reprinted from "The Outlook for International Bank Lending", a poll of 52 international banks, published by the Group of Thirty, August, 1981:

Q. 23. Do you think that the Fund itself would be able to borrow large amounts on the international financial markets and what, in your view, would be the best approach for the Fund to follow?

Respondents' Answers
(per cent)

Yes	No	N.A.
87	11	2

The simplified breakdown above needs qualification. The minority short-handed as "noes" consists of banks opposed to the concept of enlarged Fund borrowing from member countries and even more so from the markets, rather than banks which doubt the Fund's ability to borrow successfully if it so chooses.

The great majority believing that the Fund could and might, indeed, usefully borrow more from OPEC countries and other richer members, as well as from the markets, suggested a wide spectrum of possible assets that might be issued, from short-term paper to medium-term floating rate notes and, at the other end, longer-term fixed interest securities, although several banks argued against the emergence of the IMF as a competitor of the World Bank in international bond markets.

Many banks expressed the view also that IMF assets denominated in SDR might prove widely acceptable and at the same time make an important contribution to the evolution of an international market in SDR assets.

Estimates of the amounts the IMF might raise from the markets, mainly from the authorities of some member countries, from banks and, marginally, from non-bank international insitutions, ranged from "vast" (undefined) to $5 billion a year (unexplained).

A point made by several banks is that the IMF's soverign immunity would need to be waived for market borrowing and that investors might need the option of immediate redemption of outstanding SDR securities in the event of further changes in the composition of the SDR. Moreover, the IMF would need to help provide a sufficient market to give investors assurance of reasonable liquidity.

An argument against IMF borrowing or borrowing from member countries at market-related terms was that this would push up the Fund's average cost of money and thus its lending rates, even though the Fund could expect to borrow on very fine terms.

The latter prospect, however, caused some bankers to question why OPEC and other member countries should wish to invest in IMF assets at returns below those safely available from the world's leading commerical banks.

The overwhelming view that the IMF could raise large sums if it wished was precisely the reason some bankers gave for opposing such an approach. "Any borrowing by the IMF would have a 'crowding out' effect and adversely affect the fund-raising ability of private lenders" was one comment. Another bank said the "danger" of large IMF market borrowing "could be a squeeze on banks' ability to fund their loan portfolios."

It was on such grounds, possibly more widely held than expressed, that one bank commented: "The very nature of resources (borrowed from the markets) does not seem quite appropriate to the Fund's requirements," (a reference to the distinction between the roles of the Fund in tiding countries over temporary balance of payments problems and commercial bank lending intended to increase countries' net foreign exchange earning capacity over time).

Other comments included the following:

> "How would they do it? The fund certainly faced a number of mechanical problems. Can they convince the investors that they are good credit—other than the fact that this is the IMF, which although not a bank, has some kind of credit that will assure repayment?

"When you get down to it you will find that although the US banks would do a lot of typical analytical work, many European banks would simply take the view that the IMF is virtually the agency of the governments of the world, and as such would take a positive view about its credit.

"Many of them will regard the IMF in that way, that it is really the bank for the world and it would be in the interest of governments to see that it meets its obligations because if it doesn't we're going to have so many other problems to worry about this would be the least of them.

"We're telling the IMF that they should really write their prospectus and be very careful about presenting credit in the conventional way of looking at it."

Table 4
Use of the IMF's Credit and its Resources

Net Drawings (Net Repayments)

	$ billions*				
	1978	1979	1980	1981	1982
Under:					
General Resources	(2.6)	(1.6)	(1.8)	2.3	6.6
Other Facilities+	(0.5)	(4.0)	(2.0)	0.6	2.8
Total:	(3.1)	(5.6)	(3.8)	2.9	9.4

2. IMF Resources

	$ billion*				
	1978	1979	1980	1981	1982
"Usable" currencies #	14.6	11.6	13.6	27.1	19.1
IMF's SDR Holdings	1.8	1.7	1.8	6.2	6.0
Total:	16.4	13.3	15.4	33.4	25.3

Source: IMF, financial years to 30 April, *SDR data converted at SDR/$ exchange rates for each period. +other facilities are GAB (General Arrangments to Borrow), oil facility, SFF (Supplemengary Financing Facility). # usable currencies consist mainly of the currencies of the industrialized countries. All figures are rounded.

Table 5

IMF Resources and Liquidity Position

(estimates, March 1983)

	SDR billions	$ billions
Quota Resources		
1. Holdings of SDRs and Currencies Presently Usable in Loans to Members	15	16.5
Borrowed Resources		
2. Undisbursed Line of Credit (excluding GAB)	9	9.9
3. GAB Lines of Credit (½ of undrawn amount)	3	3.3
Prospective Use of Resources		
Undrawn Commitments under Existing Stand-by and Extended Arrangements	16	17.6
Of Which:		
4. To be Financed from Quota Resources	7	7.7
5. To be Financed from Borrowed Resources	9	9.9
Net Available Resources		
Subscribed Resources	8	8.8
7. Borrowed Resources (excluding GAB)	0	0
Claims on Fund		
8. Reserve Tranche Positions	21	23.0
9. Loan Claims	9	9.9

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Address inquiries to:

The Group of Thirty
Two World Trade Center
Suite 9630
New York, New York 10048
Tel: 212-775-9160

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The Future of the International Oil Market

Edwin A. Deagle, Jr.

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The Future of the International Oil Market

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Author's Note

Dr. Edwin A. Deagle, Jr. is Director of International Relations, The Rockefeller Foundation, New York, and is responsible for program development in world energy, international economic affairs, regional conflicts and international security. A graduate of the U.S. Military Academy and the John F. Kennedy School of Government, Harvard University, Dr. Deagle has held a variety of program planning and budgeting positions in the United States Government.

The Future of the International Oil Market

Introduction

The world is still in mid-passage from an energy regime of low cost gas and oil to another based on higher cost energy. The passage thus far has been full of surprises. Since 1974:

> New supplies of energy other than oil or gas have come to the market much more slowly than expected.
>
> Conservation in response to higher oil prices has been much more effective than expected.
>
> Political instability in the Middle East initially played a more significant role, and later a less significant role in the oil market, than expected.
>
> Availability of oil supplies has been much better than expected.
>
> Oil prices have risen and then fallen more than expected.

Indeed, since the Group of Thirty came into existence (1978), conditions in the oil market have changed three times. First, the revolution in Iran in 1978 removed 5 million barrels per day (MBD) of oil supplies from the market for two months or so, and real oil prices more than doubled. Thereafter, war between Iraq and Iran in 1980 removed 4 MBD from the market for nearly half the year but real oil prices changed very little. Today the war continues, yet demand for OPEC oil has fallen by nearly 50 percent since 1979, declining by 4 MBD each year in 1980, 1981 and 1982. Real crude oil prices since the beginning of 1981 have fallen by about 25 percent.[1]

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[1] In most of Europe and Japan, however, real oil prices rose in 1981 and 1982 because of the dollar's strengthening in foreign exchange markets. See Appendix 1.

Price and volume movements such as these are common in commodity markets. But the oil market is not simply another commodity market. In terms of value, oil is the largest internationally traded commodity in the world, comprising about one-fifth of world merchandise trade. The oil business is big business indeed, and its relationship with the world economy is therefore a powerful one.

This report examines that relationship and its consequences, and explores what might be done to improve the functioning of the oil market and its interaction with the world economy. The report results from discussions held over a three-year period by members of the Group of Thirty study group on energy and the world economy. The study group was formed in early 1980 under the supposition that oil market conditions are of vital concern to both oil exporting and oil importing countries, and since that time its members have sought to identify common interests among oil exporting and oil importing countries.

The members of the study group, all of whom participate in a personal capacity, are:

H. Johannes Witteveen, Chairman, Group of Thirty and former Managing Director, IMF (Chairman of the Study Group)
Abdul Aziz Al Quraishi, Governor, Saudi Arabian Monetary Agency
Ali Khalifa al-Sabah, Minister of Oil, Kuwait
Roberto Campos, Senator, Federal Republic of Brazil; former Ambassador to the United Kingdom; former Minister of Planning of Brazil
Dirk de Bruyne, Director, Royal Dutch/Shell Group
Richard Debs, President, Morgan Stanley International and former Chief Administrator, Federal Reserve Bank of New York
Andre de Lattre, former President, Credit National; former Deputy governor of the Banque de France
Otmar Emminger, former President, Deutsche Bundesbank
Nurredin Farrag, Managing Director, Arab Petroleum Investment Corporation
J. E. Hartshorn, Vice President, Jensen Associates
Jawad Hashim, Managing Director, Arab Investment Banking Corporation; former President, Arab Monetary Fund
Michiya Matsukawa, Senior Advisor to the President, Nikko Securities; former Special Advisor to the Minister of Finance of Japan
Christopher McMahon, Deputy Governor, Bank of England
Francisco Parra, Director, International Energy Development Corporation; former Secretary General, OPEC
I. G. Patel, Executive Director, Indian Institute of Management; former Governor, Reserve Bank of India
Robert Pringle, Executive Director, Group of Thirty
Robert V. Roosa, partner, Brown Brothers Harriman; former Under Secretary for Monetary Affairs, U.S. Treasury
Marina v. N. Whitman, Vice President and Chief Economist, General Motors Corporation
Ahmed Zaki Yamani, Minister of Petroleum and Mineral Resources, Kingdom of Saudi Arabia

Edwin A. Deagle, Jr., Director, International Relations, The Rockefeller Foundation (secretary of the Study Group)

The study group met twice a year or more for each of the past three years, a period of great turbulence in both the oil market and the performance of the world economy. The fact that people of such diverse backgrounds and interests engaged in these sustained discussions is an achievement in itself and proof that it is possible for oil exporting and oil importing countries to explore together their common interests.

This report reflects study group discussions but members have not been asked to sign or endorse its analyses and conclusions. All members have seen the report, but its contents and those of the appendices are in each case the responsibility of the authors.

The first part of the report contains an analysis of the oil market and possibilities for its future; the second presents a discussion of prospects for strengthening the capacity of all participants in the oil market to guard its global heritage. The third part summarizes the conclusions of the study. In addition there are three technical appendices to the report.

Edwin A. Deagle, Jr.
Secretary to the Study Group
March 1983

The Oil Market and the World Economy

Main themes of the report

The international oil market has undergone breathtaking changes in the past decade, continuing up to the very moment. Public policy on the part of both oil exporting and oil importing countries has had great difficulty keeping up with events. Moreover, the pace of market developments within the past year seems to be accelerating, with the result that the future seems fraught with unusually great uncertainty. On the other hand, evidence about what has happened during the past decade in this extraordinary market is accumulating rapidly. Paradoxically, as we learn more about the past, we seem to know less about the future.

This report attempts to cope with that paradox, and suggests the broad outlines of public policies for both oil exporting and oil importing countries. In the analysis which follows, four ideas are developed:

1. **Developments over the past decade have made the international oil market the most important — and unpredictable — market in the world, and therefore a major challenge for public policy.**

The challenge is formidable:

The international oil market is now an extraordinarily important influence on the world economy — and vice versa.

Supply and demand for energy change only very slowly, but imbalances between supply and demand can cause major changes in the demand for oil, with strong effects on oil prices. Oil price changes powerfully influence the world economy. Major changes in world economic performance, in turn, can create havoc in the oil market.

2. **As a result of its global economic importance, the international oil market is now for both oil exporting and oil importing countries profoundly important to their strategic national interests.**

Unfortunately, economic forces in the international oil market appear in the short term to reward (or punish) the strategic interests of mainly one party at a time. The unhappy result is that the long-term common interests of both oil exporting and oil importing countries in the proper functioning of the international oil market is overwhelmed by the particular interests of those being punished or rewarded by the market at the moment. As we have seen over the past ten years, these rewards and punishments are massive indeed, and it is small wonder that the global heritage residing in petroleum resources evades the grasp of public policy.

3. **Two major controversies cloud effective international action to make the international oil market the proper servant of both buyers and sellers: widespread disagreement about the degree to which the international oil market should be left to market forces or subjected to concerted government action; and great uncertainty about whether, and if so how, oil exporting and oil importing countries might collaborate to protect their common interests.**

The first controversy results from conflicting evidence about the present and uncertainty about the future. The second is a child of the past, especially from 1973 to the present.

4. **The solution to this puzzle is an array of national strategies which collectively promote stability in the international oil market but permit its basic economic forces to work:**

When the international oil market yields major oil price movements, as it did in 1979-80 and in 1982-83, it is in the long-term interest of both the oil exporting and oil importing countries to help stabilize the oil market and prevent the destruction of economic interests of the threatened party by abrupt price fluctuations;

Within this broad strategic premise, both oil exporting and oil importing countries should seek market arrangements which permit economic forces to resolve themselves efficiently and convey to all participants proper price signals;

Concerted international action to achieve these objectives does not require official negotiation. It does require the steady pursuit of elusive long-term national interest in the face of attractive short-term advantage when one party or the other enjoys market rewards. This is a formidable challenge. But national efforts of individual countries toward this goal would be greatly enhanced if oil exporting and oil importing countries could discuss these matters with one another. The right year to make a start could be 1983.

Oil in World Output and Trade

Since 1973 a powerful relationship has developed between the oil market and the world economy. From 1960 to 1973, the amount of energy of all forms consumed in production in industrialized countries was relatively constant, at about 5 barrels of oil equivalent per $1,000 of GDP; by 1980 the equivalent figure was 4.4 barrels per $1,000 (in constant dollars) of GDP — a fall of more than 10 percent. Similarly, the amount of oil required to produce $1,000 of GDP fell from 2 barrels in 1973 to 1.7 barrels in 1980 — a decline of 15 percent. But this increased economy in the amount of energy required to produce a given amount of final output was then offset by the quadrupling of real oil prices since 1973. Calculated in 1980 dollars, for example, $1,000 of 1980 GDP required $52 worth of oil compared with $15 in 1973. Fuel substitution and conservation have lagged far behind changes in oil prices; and sudden changes in energy prices now have far stronger effects on national economies than was the case in 1973.

Because of its size, the oil market has far-reaching influence on trade relationships and the pattern of international payments imbalance. Measured by the average spot product price, the world oil market in 1980 was worth $850 billion. If half the market transactions were international (which seems reasonable), the oil market constitutes 80 percent of world fuels trade, which in turn now accounts for 25 percent of world trade, against 9 percent in 1970.[1]

World trade, itself, grew in the 1970s much faster than GDP. The 16 percentage-point increase in energy's share of trade considerably exceeds the United States' 1980 share of world trade. Financing the 1970s' increase in international energy trade is equivalent, in other words, to finding the funds to purchase all the exports of another United States. The domestic economic effects of the growth in energy costs as a factor of production thus are powerfully compounded by the balance of payments effects arising from the much more rapid growth of energy payments in world trade.

Sheer size is not the only factor contributing to the international oil market's effect on the world economy. Even more important are the consequences of two other characteristics of the energy market: these are, first, that both the supply and demand of energy are extremely price inelastic in the short and medium term; and, second, that the international oil market balances energy supply and demand. A slight mismatch between energy supply and demand thus is greatly magnified in the oil market, with enormous price pressures as a result. In the 1970s, relatively small changes in the availability of OPEC oil supply amidst tight energy market conditions produced two oil price explosions with profound effects on the economies of the oil importing countries. In the early 1980s, protracted world-wide recession and conservation have dramatically reduced demand for oil, putting downward pressure on its price.

---

[1] *World Development Report 1981*, The World Bank, August 1981, p. 20.

Table 1

Changes in Energy and Oil Consumption Relative to GDP

(OECD Countries[1])

(Annual % changes)

	1960-73	1973-78	1978-81
Energy Consumption per unit of GDP	0.1	−1.6	− 3.2
Oil Consumption per unit of GDP	2.5	−1.9	− 6.8
Gasoline Consumption per Car[2]	−0.2	−1.4	− 6.5
Oil Consumption per unit of Consumption Expenditure, Residential/Commercial Sector	2.1	−4.5	− 7.6
Heavy Fuel Oil Consumption per unit of GDP	5.9	−5.9	−10.1

[1] Total OECD energy and oil consumption includes tankers.

[2] Seven largest OECD economies for which car stock data have been assembled.

Source: *World Energy Outlook*, OECD/IEA, 1982, p. 72.

Evidence is gradually accumulating, as Table I shows, that the oil price increases of the 1970s have stimulated the industrialized countries toward energy efficiency generally, toward substitutes for oil particularly, and especially toward substitutes for OPEC oil.

In the United States, for example, real economic economic growth between the end of 1979 and the end of 1981 was 1.5 percent.[2] Energy demand for the same period declined by 5.7 percent; oil demand by 12.2 percent and imported oil demand by 32.5 percent.[3]

What is unclear is how much of the decline in oil demand can be attributed to the cumulative effects of past oil price increases (which induce conservation and fuel substitution) and how much can be attributed to recession and the depressed economic state of energy-intensive industries in the OECD countries. A further uncertainty is the extent to which conservation and fuel substitution induced by past oil price increases are permanent and irreversible, or will be reversed in part by the effects of the recent decline in the real price of oil. A third element of confusion is whether the current trend of increased energy efficiency will continue in the future or soon reach a plateau, with the result that economic growth in the future will be matched by renewed growth in energy demand.

If most of the decline in energy and oil use can be attributed to permanent conservation and fuel substitution, and if the trend continues, the world economy may be less influenced by the international oil market in the 1980s than it was in the 1970s. If, on the other hand, most of the current decline in oil use can be attributed to some combination of reversible conservation and oil substitution (that is, less conservation and extensive fuel switching back to oil as a result of falling real oil prices) and to the temporary recession in energy-intensive industries, then the relationship between the international oil market and the world economy will remain strong and potentially disruptive.

Under these circumstances, a combination of economic recovery in the OECD countries over the next several years and a substantial decline in real oil prices from 1981 to the end of 1985 or so could produce a dramatic increase in oil demand later in the decade. With the oil market tight once again, the stage would be set for another price explosion in the event of a supply disruption. Rapidly rising oil prices, in turn, would produce major economic losses in the world economy, followed by steep decline in demand for oil, and then revenue losses in the oil exporting countries.

Over the long run this kind of volatile commodity market behavior in the international oil market and its powerful effect on the world economy would spell disaster. Each time oil prices fall they destroy the financial estimates which underpin investment decisions for development of more costly new energy supplies. Failure to develop new energy supplies makes the world much more vulnerable to the economic effects of sudden oil supply disruptions and concomitant oil price explosions, and ultimately raises the spectre of real energy shortages at the end of the century.

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[2] *OECD Economic Outlook*, #30, December 1981.

[3] *Monthly Petroleum Review*, Merrill Lynch, Pierce, Fenner & Smith, Inc., November 1982, pp. 42, 44.

As we have noted, the evidence about the determinants of changes in energy and oil demand is not yet conclusive. In the absence of such evidence, it is prudent to act on the supposition that the relationship between the international oil market and the world economy remains capable of unexpectedly punishing either buyers or sellers in the oil market. As we argue later in this report, it is even possible that this relationship may grow more unstable and potentially destructive in the 1990s.

The Strategic Importance of Oil

The geographic concentration of oil, especially in the Middle East, invests it with immense strategic importance to both buyers and sellers, and thereby adds anxiety and uncertainty to the oil market.

For the oil importing countries the strategically important facts are that in the short run there are few substitutes for oil and that a long-lasting interruption of oil supply would cause enormous economic damage. It is hardly surprising, therefore, that when the market is perceived to be "tight," panic buying can quickly set in. In both 1973-74 and 1979-80, the actual level and duration of supply interruption were not severe enough *physically* to damage oil importing country economies; the damage came from the *economic* effects of massive price movements. In both instances, the rapid increase in oil prices reflected — in part — anxiety among oil consumers about security of supply and not just the actual physical availability of supply in the marketplace. When this happens, prices contain a premium reflecting concerns about insecurity of supply not necessarily related to the general scarcity value of oil. Over the medium term, an insecurity premium in the oil price will cause consumers to desert Middle East oil earlier than is economically warranted, penalizing buyers in the short run and sellers in the long run. In the short term each political crisis and the attendant episode of panic buying triggers the sensitive cyclical linkage between the oil market and the world economy.

The strategic importance of oil to many oil exporting countries is doubtless even greater than to oil importers. Most of the oil exporters are developing countries for whom oil, a precious nonrenewable asset, is the central feature of the national patrimony. For these countries the strategic challenge is to exchange the value of oil below the ground for the foundations of diversified, sustainable economies above the ground. For surplus oil exporting countries with small populations relative to the size of their oil reserves, production of oil at levels higher than needed to finance development — in exchange for overseas financial assets — may not always be in the national interest. Indeed, some of these countries believe that they serve their interests best by limiting production and lengthening the period for which oil revenues will be available. To the extent that this sentiment prevails, it creates inelasticity of oil supply, since higher prices will not necessarily elicit more supply from those countries.

Glut in the oil market in 1981 and 1982 has created a new strategic concern among the oil exporting countries. Most of them have embarked upon development programs that depend on a stable flow of oil revenues. Surplus oil exporting countries such as Saudi Arabia, Kuwait and the United Arab Emirates have some capacity to insulate their economies from major shifts in oil demand. But the other OPEC countries and some non-OPEC oil exporting countries cannot avoid the domestic economic shocks that result from a steep decline in oil revenues such as occurred in 1981 and 1982 (see Tables 2 and 3).

Table 2

Recent Changes in OPEC Oil Production

*(Oil Production in MBD)**

Country	April 1980	April 1982	November 1982
Saudi Arabia	9.765	6.629	5.617
Iran	1.800	1.600	2.600
Iraq	3.500	0.800	0.800
Kuwait	1.555	0.679	0.917
U.A.E.	1.705	1.226	1.157
Qatar	0.500	0.232	0.310
Venezuela	2.050	1.490	2.300
Nigeria	2.190	0.888	1.355
Libya	1.750	0.600	1.700
Indonesia	1.550	1.244	1.400
Algeria	1.000	0.600	0.800
Gabon	0.180	0.150	0.140
Ecuador	0.250	0.200	0.200
Total OPEC	27.795	16.337	19.316

* Excludes natural gas liquids production

Source: *Monthly Petroleum Review*, Merrill Lynch, February 1983, p. 23.

It is doubtful whether any oil exporting country over time can insulate its economic development from the major swings in the oil price and demand that have occurred in recent years.

The fundamental importance of oil to oil-importers and exporters inevitably makes it extremely difficult for them to work together to fortify their common interests in the functioning of the world oil market. Indeed, the volatility of oil prices in recent years makes the risk adjusted cost of either importing or exporting oil higher than its price — a reflection of the new strategic importance to oil in the importing countries.

Table 3

OPEC Current Account Balances

(billions of U.S. dollars)

	1980	1981[p]	1982[e]
Exports	304	281	253-255
Imports	133	159	175-183
Trade Balance	171	122	70-80
Net Invisibles	(61)	(57)	(55)
Current Account	110	65	15-25

[p] — preliminary
[e] — estimate
( ) — denotes negative
Source: OPEC Secretariat, 1982

A recent analysis of the true cost of United States oil imports, for example, concluded that taking into account a broad range of future oil market conditions and possibilities for supply interruptions, the cost to the United States of importing oil is higher than the market price, and therefore it would be advisable to impose an oil import tariff ranging from 43 to 98 percent of the price of imported oil.[4]

One can imagine a comparable analysis for an oil exporting country producing the conclusion that a tariff should be levied by the government on its oil revenues, to capture the social costs involved in exporting oil in a volatile international market. Such protectionist calculations obscure the value of trade, but they indicate the cost to both oil importing and oil exporting countries of price shocks in the oil market. This is the heart of what is jointly at interest for both parties. Unfortunately, major price movements in the international oil market — especially if sudden and unexpected — punish only one party at a time and reward the other. Thus it becomes very difficult for both parties to agree on the value of working together to protect their common interest in market stability, as the dismal diplomatic record of the past decade attests.

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[4] *Oil Gluts and Oil Tariffs*, William W. Hogan, Harvard Energy Security Program Discussion Paper, May 1982.

Influence and Control in the Oil Market

In public discussion, OPEC tended to be viewed in the 1970's as an invincible monopoly or cartel; now there is a tendency to claim that this power has been weakened, if not broken. In fact OPEC market power in the past has been somewhat overestimated, as its present market power may be underestimated. The basic source of OPEC influence in the oil market rests in the geologic fact that, for the foreseeable future, oil in the Gulf region of the Middle East will remain the lowest cost source of energy in the world, and its price can be adjusted to meet almost any conceivable market conditions. On the other hand, economic forces in the oil market are, as we have noted, indeed powerful over time. Price maintenance under conditions of weak demand requires production ceilings very difficult to coordinate. Contemporary power relations in the oil market therefore are complex and tend to oscillate cyclically, and are exercised very differently than by the "Seven Sisters" in their heyday.

OPEC countries obviously have been successful in getting control of their oil extraction industries; in shifting the oil pricing system away from cost of production toward economic rent based on scarcity; in capturing a large portion of that rent for themselves; and in managing to insure that sufficient oil flows despite disruptions in particular member countries. However, contrary to a widespread public impression, OPEC has never simply raised oil prices through the unilateral application of market power. In both 1973-74 and 1979-80 political crises triggered a temporary interruption of oil supply — one deliberate, the other unintended — which was followed by panic buying in the spot oil market. OPEC countries thereafter adjusted official prices and added premiums and surcharges to capture the market realities expressed in spot prices. OPEC market power has been most effective in preventing oil prices from tumbling in slack markets. But that power too has been limited; OPEC was unable to adopt policies to prevent a 10 percent decline in the real price of oil from 1975-78, and a 25 percent decline since 1981.[5]

Not the strength of OPEC, but rather the collective weakness of the industrialized oil importing countries has until recently been the most important fact about oil market power. These countries have not yet developed the capacity to adjust their aggregate demand for oil to the state of the market, even in emergencies, or to cope with the economic problems that in part result from, and at the same time contribute to, the instability of the oil market. The United States has only recently begun to install national policies — mainly in the form of price decontrol — which will contribute to demand restraint. Collectively the industrialized oil importing countries have developed only relatively weak emergency arrangements for coordinated stock management, and these are oriented toward minimizing supply disruption rather than influencing the behavior of prices.

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[5] In dollars only; the price of oil in Europe and Japan rose in much of 1981 and 1982 because of exchange rate changes. See Appendix 1.

Moreover, structural changes in the oil industry may contribute to oil market instability in the future in ways that will make new policy demands on the industrialized oil importing countries. In the 1950s and 1960s the international oil companies coordinated a fully integrated system from wellhead to consumer. Now the international oil companies are less involved in crude oil production and product retailing, and more involved in trading. Partly as a result, spot and futures markets have joined (at the margin) inventories as hedges against oil market movements. If industry stock levels become less important for seasonal and cyclical fluctuations and thus are reduced, the oil industry may be less able to cope with supply disruptions. Government strategic stocks, sharing arrangements and surge production capacity would become more important than today.

The collective ability of the oil importing countries to act as stabilizing forces in the oil market, given its potential volatility, remains very much in doubt. Moreover, there is little evidence that individually or collectively the industrialized countries recognize their strategic interests in ensuring that oil prices do not fall too far, too quickly. In short, it is highly questionable whether current oil market policies in the West are adequate for the 1980s.

Some maintain that the oil market is finally becoming competitive and should therefore be left alone, so far as politically possible, while others believe that the oil market is inherently unstable, is too important to be left to market forces, and must be conditioned by government policies. This debate is explored further in Part III of this report. In the meantime, it is worthwhile exploring what the future might hold for this extraordinary market.

Supply and Demand through 1990

Predicting the oil market, even in the short term, is a hazardous business; most forecasts made in the past ten years have been very much in error.[6] Nonetheless it can be useful to estimate the range of possibilities and analyze what combinations of circumstances are likely to produce one outcome versus another. In the case of non-oil energy markets, many trends in supply and demand are now becoming clearer. In the near future most new supplies will come from coal, natural gas and from nuclear power stations already under construction, as a recent estimate in Table 4 indicates.[7]

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[6] See *Energy in the 1980s: An Analysis of Recent Studies*, Group of Thirty, 1980, and "Oil Demand and Energy Markets: An Interpretation of Forecasts for the 1980s", Edwin A. Deagle, Jr. and Bijan Mossavar-Rahmani, *OPEC Review*, Fall, 1982.

The outlook for the remainder of the decade is quite uncertain. The major imponderables are three: demand for OPEC oil, particularly from the OECD countries; supply of OPEC oil, particularly from the Gulf; and changes in oil inventory (stock) levels. Because the relationship between oil inventories and the balance between supply and demand recently has been unusually important and is not well understood, it is useful to examine the role of oil stocks since 1978.

Table 4

Projected Non-Communist World Primary Energy Consumption

(million barrels per day of oil equivalent)

	1980		1990		2000	
	MBDOE	(%)	MBDOE	(%)	MBDOE	(%)
Oil	49	(50.6)	53	(43.4)	54	(34.6)
Natural Gas	18	(19.2)	23	(18.9)	26	(16.7)
Coal	20	(20.8)	22	(18.0)	40	(25.6)
Hydropower	7	(7.3)	8	(6.6)	10	(6.4)
Nuclear	3	(3.1)	11	(9.0)	15	(9.6)
Synthetics	—	—	3	(2.5)	7	(4.5)
Renewables	—	—	2	(1.6)	4	(2.6)
Total	97	(100.0)	122	(100.0)	156	(100.0)

Source: 1980 figures adapted from British Petroleum (1981), 1990 and 2000 figures adapted from Exxon(1981), by Bijan Mossavar-Rahmani.

The Role of Stocks

The world oil induustry at the end of 1980 maintained about 10 billion barrels of oil inventory worth well over $300 billion in the complete supply chain from wellhead to consumer-about six month's supply.[8] Only about half this amount, 5.0-5.5 billion barrels of primary inventory, is within reach of industry or government control, and only three-quarters of that is monitored through data routinely obtained through government reporting systems in the United States, Western Europe and Japan. Rough estimates must be made of all the rest, and as a result all stock estimates have a built-in margin of error. Most of the 5 billion barrels of primary inventory is not easily available in the event of a supply emergency, since part of it is required to keep the pipelines and storage facilities of the supply system operational. Exxon estimates that in 1980-81 the oil industry maintained between 1.0 and 1.5 billion barrels (varying by season) of commercially usable stocks — that is, stocks which can be drawn down without damage to the distribution system. This was about 500 million barrels above the normal pattern of the 1970s (and worth $17 billion).

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[7] Appendix 2 contains a discussion of non-oil supply prospects between now and the year 2000.

[8] *World Oil Inventories*, Exxon Corporation, August 1981.

Seasonal variation in demand between winter peak and summer floor can be as much as 5 to 6 MBD, and the oil industry uses its stocks to smooth out these seasonal variations. The oil industry routinely destocks in the winter and restocks in the summer at the rate of 2 to 3 MBD, changing its inventories seasonally by as much as 500 million barrels.

At the time of the Iranian revolution, free world commercial oil stocks were at slightly below normal levels — about 80 days of supply at the end of 1978.[9] The drop in Iranian supplies prompted companies to deplete stocks in the first quarter of 1979 by more than 500 million barrels, severely diminishing usable commercial stocks. Thereafter the oil industry began to accumulate and maintain higher stocks, and by the third quarter of 1980 stock levels were about 500 million barrels above normal. Availability and use of these excess stocks at the rate of about 3 MBD during the winter of 1980-81 seems to have contributed to the relative stability of the market in the face of disruption from the war in Iran and Iraq in 1981. For more detail see Appendix 3.

Until recently, high interest rates have made this form of market stability expensive — about $8-9 per barrel per year, or $4.0-4.5 billion per year for 500 million extra barrels.[10] Unless oil prices were expected to rise by at least 25 percent per year, holding excess oil stocks was a costly proposition. There is, indeed, growing evidence that high interest costs and expectation of a soft market for several years have prompted an unexpected inventory liquidation to below normal levels, as displayed in Table 5.

In the summer and early fall of 1981, instead of rebuilding stocks at the rate of about 2.0 MBD, industry was destocking at the rate of about 1.5 MBD, thus lowering the apparent demand for OPEC oil by about 3.5 MBD. Combined with the effects of increased conservation and depressed economic activity in the industrialized countries (especially in Western Europe), the unusual summer and fall destocking lowered apparent demand for OPEC oil in the third quarter of 1981 to about 21.6 MBD and in the fourth quarter to 22.0 MBD. Over the year, stocks may have been reduced overall by about 170 million barrels.[11]

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[9] Figures from *Monthly Petroleum Review*, Merrill Lynch, Pierce, Fenner & Smith, Inc., February 1983, p. 19. Different institutions maintain inventory estimates for different groupings of countries. Exxon maintains figures for the whole world. Merrill Lynch estimates for the free world are typically about 300-500 million barrels lower.

[10] *World Oil Inventories*, op. cit., p. 14.

In 1982 destocking was even heavier, especially in the first quarter when stocks were drawn at the rate of about 3.3 MBD. By the end of 1982 stocks were estimated to have been reduced by 450 million barrels or more. And, according to first quarter estimates for 1983, stocks fell by another 378 million barrels to 4.3 billion barrels. Since 1980 stocks may have fallen by nearly a billion barrels, wiping out most of the excess inventory accumulated in 1979 and early 1980. Thus at the end of the first quarter, 1983, demand, supply and inventory supplies appear to be unexpectedly low. (See table 5) What might then ensue between 1983 and 1990?

A Pick-up in Demand?

On the demand side the determining issues are likely to be two: the timing and extent of economic recovery in the industrialized countries, and the extent to which economic growth is matched by growth in energy and oil demand.

A substantial fall in real oil prices (say, to $20 per barrel) would benefit importing countries and spur economic recovery — and thus demand for oil later in the decade — but would also carry new risk and dangers. These would be of three kinds:

> First, oil exporting countries, including not only OPEC countries but also Mexico and other oil exporting countries, would suffer powerful shifts in terms of trade — the international purchasing power of their oil exports would decline.
>
> Second, the "forced savings" effect of OPEC country surpluses would disappear, possibly making it more difficult for the international monetary system to finance current account imbalances of oil importing or exporting countries. This means that these countries must absorb more of the burden themselves, through domestic economic austerity strategies. Both of these factors could add further to the strains on the international financial system, at least in the short run.
>
> Third, falling real oil prices would cause investment in alternative energy sources to decline. Most high cost energy supply projects have been recently postponed or cancelled, presumably in response to changed expectations about the future of oil prices. If this trend continues, changes in the balance of energy supply and demand will have to be reconciled to an

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[11] *Monthly Petroleum Review*, Merrill Lynch, Pierce, Fenner & Smith Inc., November 1982, p. 19.

Table 5

Free World Oil Supply/Demand Balance, 1977-83

(Million Barrels Per Day — MBD)

								1982E			1983E
	1977	1978	1979	1980	1981	1Q	2Q	3Q	4Q	YR	1Q
Demand (MBD)											
U.S.	18.5	**18.8**	18.4	17.1	16.0	15.8	15.3	14.8	14.8	15.2	15.1
Foreign	31.5	**32.6**	33.7	32.4	31.1	31.5	28.9	28.6	30.0	29.8	29.8
Total	50.0	**51.4**	52.1	49.5	47.1	47.3	44.2	43.4	44.8	44.9	44.9
Supply (MBD)											
OPEC	31.8	**30.3**	31.4	27.4	23.2	20.1	18.1	18.9	20.0	19.3	15.7
Non-OPEC	18.3	**20.8**	22.1	22.3	23.3	23.9	24.3	24.5	25.0	24.4	24.9
Total	50.1	**51.1**	53.5	49.7	46.5	44.0	42.4	43.4	45.0	43.7	40.6
Inventory Gain* (MBD)	0.1	**(0.3)**	1.3	0.2	(0.6)	(3.3)	(1.8)	(0.0)	(0.2)	(1.2)	(4.3)
Inventory Levels* (Million barrels)											
Begin	4,690	**4,728**	4,537	5,062	5,290	5,125	4,828	4,665	4,665	5,125	4,683
Change	38	**(191)**	525	228	(165)	(297)	(164)	(0)	18	(442)	(378)
End	4,728	**4,537**	5,062	5,290	5,125	4,828	4,665	4,665	4,683	4,683	4,305

Source: *Monthly Petroleum Review*, Merrill Lynch, Pierce, Fenner & Smith, Inc., February 1983, pp. 18-19. Corrected.

* Inventory figures are derived arithmetically from differences between supply and demand and therefore convey the impression of much more precision than is warranted by measurement/estimation systems. In addition, OPEC secretariat figures for inventory change are likely to show steeper inventory drawdown in 1982. The OPEC projections for 1982 inventory changes otherwise show a decline in OECD stocks of from 588-666 million barrels.

> even greater extent than anticipated in the oil market itself. Moreover, weak oil prices could ultimately affect the exploration and development of oil resources both within and outside OPEC countries. Thus falling real oil prices over time could simultaneously stimulate demand for oil and truncate the development of new oil resources.

In such circumstances, much will depend on the oil inventory policies of the oil industry and interested governments. If structural changes in the oil industry continue to reduce the perceived need for industrial stocks, and if at the same time oil exporting countries devote less resources toward maintenance of excess production capacity, then the pressures on the market and the potential volatility of oil prices will increase dramatically.

Thus developments between now and 1985 could give rise to unexpected increases in oil demand in the latter part of the decade, and very sharp increases in the demand for OPEC oil. For reasons we point out in the next section of the report, most of these shifts in demand would fall on the Gulf oil exporting countries.

On the other hand, it is still possible that oil demand through the decade will be stable, that is, rising gently and predictably or remaining relatively flat. Real oil prices would stay roughly the same through 1985 and rise a bit through the rest of the decade. Expectation of a firm real oil price rise would restore some investment in new energy resources, including new Gulf surplus production capacity and industrialized country strategic reserves, if needed. Oil importing developing country programs to enlarge their domestic energy supplies and enhance conservation might be given new impetus.

In early 1983 it is very difficult to know which of these two visions — or others — might become history by 1990 or thereafter. But the difference clearly matters to those who make public policy.

The Oil Market in the Medium and Long-Term

If short-term forecasting is hazardous, medium and long term forecasting is surely foolhardy. A report prepared for the Group of Thirty summarizing and assessing some 100 studies and projections of future energy supply and demand prepared over the past 10 years, found that these studies present an astonishing range of future possibilities. For example, the mean of estimates of 1985 world demand for OPEC oil in studies prepared in the 1974-75 period was 38.5 MBD; for studies prepared in 1977-78, 41.0 MBD; and for studies prepared in 1979-80, 34.3 MBD.[12] Since the oil glut began in 1981, some analysts have suggested that demand for OPEC oil in 1990 may be no more than 15 MBD and could be as low as zero!

No explicit forecast for 1990 and beyond is therefore attempted here.

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[12] *Energy in the 1980s: An Analysis of Recent Studies, op. cit.*, p. 15.

Instead two key factors that will shape the energy markets of the future are presented for analysis.

The most important determinant of future energy markets may be the implicit race between fuel substitution and conservation in the industrialized oil importing countries and the growth in net petroleum demand in the developing countries, especially the oil-exporting developing countries themselves. Good or poor performance by one side or the other will drastically alter the oil supply/demand balance OPEC countries would face in the market. Table 6, containing three different estimates of 1990 free world oil demand, estimates of non-OPEC production, and implied levels of required OPEC production, hints at the range of estimated possibilities.

However, these are all point estimates — snapshots of 1990 energy futures derived from relatively crude arithmetic. Revolutions, wars, new inventions and other energy surprises undoubtedly will mark the difficult passage between the present and the uncertain future of the 1990s. One point seems certain: if the combination of circumstances which take place between now and 1990 yields a third price explosion, the race between OECD oil conservation and rising developing country oil demand will be overshadowed — catastrophically, for all — by profound economic loss. Less dramatic, but disastrous nonetheless, is the possibility that continued recession, misguided policies in the industrialized countries, and OPEC inability to manage production could result in a continuing short-term decline in the real price of oil, postponing the availability of new and more

Table 6

1990 Free World Oil Balance Estimates

(Million barrels per day)

	CONOCO	EXXON	IEA/OECD[b]
Demand			
Industrialized Countries	40.0[a]	36.0	35.5
Developing Countries	11.7[a]	17.0	17.5
Total	51.7	53.0	53.0
Supply Requirement			
Non-OPEC Production	28.7	25.0	23.0
OPEC supply required to balance	23.0	28.0	30.0

Source: Exxon, March 1982; Conoco, January 1982.

[a] Estimated from graphs, charts and other data in studies cited.

[b] IEA/OECD, October 1982. (Figures are averages of two scenarios).

expensive energy supplies and sowing the seeds of political and economic disruption among the oil exporting countries.

The Key Role of the Gulf Countries

The second major influence on the future oil market could be the further concentration of effective market power in the countries of the Gulf, and the way they will use that power. In the course of this decade OPEC is likely to undergo important shifts in the relative market power of its members. By 1990 four OPEC members — Algeria, Ecuador, Gabon and Qatar — may each have the capacity to export about 0.5 MBD or less. Indonesia, Libya, Nigeria and Venezuela could export more than this but may have little elbow room to adjust production to market circumstances. The remaining five oil exporting members of OPEC would consist (with the notable exceptions of Iran and Iraq) of countries with low populations and substantial oil or financial reserves. Assuming the war between Iraq and Iran ends, these five Gulf countries by 1990 are likely to share among themselves the power to adjust OPEC oil exports by more than 10 MBD, as Table 7 indicates. Other countries outside of OPEC — Mexico, Norway, perhaps even Egypt and China — may become more significant oil exporters. None of them, however, are likely to be able to adjust production as easily in response to market conditions as can the key five countries in the Gulf, and first among them, Saudi Arabia.

Whether or not these Gulf countries will use their continuing power to stabilize the oil market will depend on a number of factors. Clearly one of the most important is the behavior of oil prices. Another is the value of financial and real assets these countries receive in exchange for exporting oil at levels above the level required to finance their development needs; more will be said about this later.

In any case it is evident that the decline in OPEC's share of world energy (and oil) production over the next two decades is misleading insofar as it is thought to affect market power. The power to balance the oil market — and thus all energy markets — may be more concentrated in the 1990s rather than less. It will gravitate to those countries which can afford to adjust production significantly enough to shift market conditions.

While the Gulf countries may dominate OPEC exports, these exports are likely to represent a somewhat smaller share of free world oil trade (35 percent as compared to 53 percent at present); and that oil trade, in turn, is likely to represent a much smaller proportion of supply in world energy markets.[13] This implies that to exercise their potential power the Gulf countries must be able to adjust production to meet a much broader range of oil demand levels than has been in the case in recent years.

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[13] *World Development Report 1981*, IBRD, p. 39. For example, the World Bank estimates that of new energy supplies in the 1960s, 62 percent was new oil production; during the

To put the issue another way: unless the Gulf countries are prepared to absorb most of the swings in oil demand, the market's inherent instability would be further exacerbated, especially if the oil industry relies less in the future on excess stocks on balance market pressures than it has in the past.

To summarize, the world may face by the last years of the century the paradox in which the oil exporting countries in the Gulf become slightly *less* important as contributors to global energy supply, and much *more* important as potentially stabilizing or destabilizing influences. It is likely to become progressively more difficult for these countries to adjust production sufficiently to influence oil prices, making for potentially greater market volatility in the 1990s. Managing the matching of their oil production to wide swings in oil demand may require the provision of substantial — and relatively liquid — financial assets to tide them over in periods of weak oil demand.

Table 7

OPEC 1990 Production Range Estimates

(Million barrels per day)

	Low	High
Saudi Arabia	5.0	11.0
Iran	3.5	5.0
Iraq	2.0	3.5
Kuwait	0.8	2.5
UAE	1.3	2.0
Total	12.6	24.0

Source: Estimates by author and Bijan Mossavar-Rahmani.

General Conclusions

Mindful of the fact that forecasting the future of energy markets is hazardous, several general conclusions can be drawn from the analysis thus far:

> Oil, because it is so critical to the world economy and is relatively cheap to extract, will remain the premium residual energy source (and therefore its

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1970s, oil accounted for 41 percent of new energy supplies; the 1980s estimate is 25 percent; the 1990s, 5 percent.

market the energy price setter) well into the next century. But in areas other than the Gulf region of the Middle East, oil is becoming more difficult to find and extract and therefore more expensive. Accordingly, the oil exporting countries of the Gulf are in the energy market to stay, at least for the rest of the century.

Oil importing industrialized countries have much to do to improve their collective performance in contributing to stability in the oil market.

Because of some inherent characteristics of the market, price movements are likely to continue to exhibit strong fluctuations. Instability could be worsened not only by new shocks but also by shifts in market power.

The market will retain the potential to damage the interests of both oil exporting and oil importing countries.

It is therefore in the interest of all parties to improve the economic functioning of the oil market and see to its stability.

But how is this to be done?

Compatible Policies Among Oil Exporting and Oil Importing Countries

This part of the report examines the debate between *laissez faire* and *dirigiste* theories about the oil market and then sets forth suggestions about specific policies, mechanisms and institutional arrangements for improving the oil market and its relationships with the world economy.

The Case for Joint Efforts to Improve the Oil Market

It is not at all obvious that the public interst is served by attempting to improve the structure and operations of the international oil market. Indeed, it is often argued that government intervention and price and production management by the international oil companies prior to 1973 are the principal reasons why the oil market has performed badly and made the energy transition so painful. Price management, from this view, is almost sure to fail: the oil companies priced oil too low in the 1960s and OPEC priced it too high in the 1970s. Who knows how it should be priced in the 1980s? If the oil market is volatile, that is the price to pay to ensure that it conveys the correct economic signals and helps the world navigate the energy transition efficiently. Decontrol, in this view, is not only the best policy; it is the only policy in light of how little is really known about the energy future.

On the surface this is a powerful set of arguments. If one could be assured that the oil market functioned reasonably well, a free market policy would clearly be superior. But the fact is that with the exception of the spot and futures crude oil and refined product markets, the oil market has always had relatively few of the attributes of a competitive market. Moreover, as outlined earlier, the oil market's short-term behavior driving not only from the susceptibility to shocks of various kinds but also to certain structural features of the market, severely constrains its long-term economic function as the price setter in world energy markets. In terms of economic efficiency oil prices are more sensitive, at least in the short run, to security of supply concerns and world economic performance than to the price of energy substitutes. Moreover, the cyclical volatility of oil prices and buyer/seller power relationships prompt little confidence that oil prices over time will property signal the long-run availability (or scarcity) of oil.

Higher oil prices only gradually promoted increased supply of alternative sources of energy. In part this is because the capital investment required to shift world reliance on energy away from oil is enormous and the process takes time. But it may also be true that the behavior of real oil prices — particularly their sharp increase in 1979-80 and decline in 1975-78 and

1981-83 — has failed to convey the correct economic signals about the long-term value of oil relative to its substitutes.

Cyclical volatility in the oil market inflicts severe economic blows successively on buyers and sellers and increases the stakes for each side in gaining advantage following a reversal in the market. Thus volatility breeds further instability, a strong tendency to blame one's misfortune on the other side, and great uncertainty about future profitability. Certainly investment in alternative energy supply has lagged badly.

A substantial portion of new energy supplies will come from the Arab OPEC countries. A recent study — admittedly tentative — of required investment to enable the Arab petroleum industry to sustain oil output equivalent to its 1977-80 average of about 22 MBD and maintain its current reserves-to-production ratio concludes that $331 billion will be required between now and the year 2000.[1] Of this total, $240 billion would be needed for new exploration and development, $11 billion for enhanced recovery and $80 billion to develop gas reserves. In addition, the study estimates that $159 billion would be required if refineries planned or under construction are to be completed on schedule.

Investments of this magnitude, like those for new energy supplies in the oil importing countries, will not be made if investors cannot foresee profitability because of great price uncertainty in energy markets. In particular, these investments will not take place if real oil prices decline substantially in the short-term, because investors in the industrialized countries will be unwilling to make them, and governments in the oil exporting countries will be unable to afford them.

If there is justification for intervention in the market, it is to improve the prospects that such investments will be made. For the oil *importing* countries — both industrialized and developing — less volatile oil market conditions would also permit diversification of oil supplies and adjustments to higher energy prices without excessive economic losses. The oil *exporting* countries would face more predictable export revenues and current account positions.

The surplus oil exporting countries would benefit from enhanced economic performance of their real financial assets in the oil importing countries, and from a gradual lowering of strategic concerns in the West about security of supply. Lowering the political and military temperature in the Middle East would certainly be attractive to most countries, especially the Gulf oil exporting countries.

Improving the economic functioning of the oil market and reducing its price volatility may in fact be both a reason for, and a goal of, better public policy for the market, as is argued here. But how is it to be done? Answers to this question are suggested in the next two sections of the report.

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[1] Summarized in *Petroleum Intelligence Weekly*, April 19, 1982, p. 8.

Improving the Economic Functioning of the Oil Market: The Real Side

Until very recently, the major structural problems in the oil market were seen to be ones that produced consistent upward pressure in oil prices and great vulnerability to price explosions when the market became tight and a political crisis occurred. The best solution to such unruly market conditions was thought by many to be a scheme of price setting arrangements, which would not produce free market conditions but might stabilize prices.

The case for oil price fixing rests on the proposition that the oil market is unlikely to acquire the characteristics of a competitive market, for the reasons outlined earlier. Therefore, the argument goes, reasonable stability is of first importance, and if price fixing deprives the market of its ability to send accurate economic signals as a results, so be it; the trade-off is a reasonable one.

But recent events indicate that the oil market may be acquiring some of the functional capabilities of an economically competitive market. The evidence, as pointed out earlier, is unclear. But if the opportunity exists, the basic strategy ought to be to improve the economic functioning of the oil market, rather than to lock up its price structure.

Price controls should be seen only as a standby solution, since such controls cripple the economic signaling and market clearing functions of prices. If prices are set too low, the world would use too much oil too quickly, before alternatives to it were available in quantity. Serious shortages could then result with fewer options to deal with them than today. On the other hand, if the price is set too high, the world would suffer unnecessary economic losses and would invest in energy supplies more expensive than true economic conditions warranted. Eventually the price control regime would collapse.

The keys to better oil market economic performance are twofold: (1) strengthening the relationship between short-term oil price movements and the long-term scarcity of oil, and (2) improving the ability of the oil market to absorb shocks in supply and demand. The two elements are related.

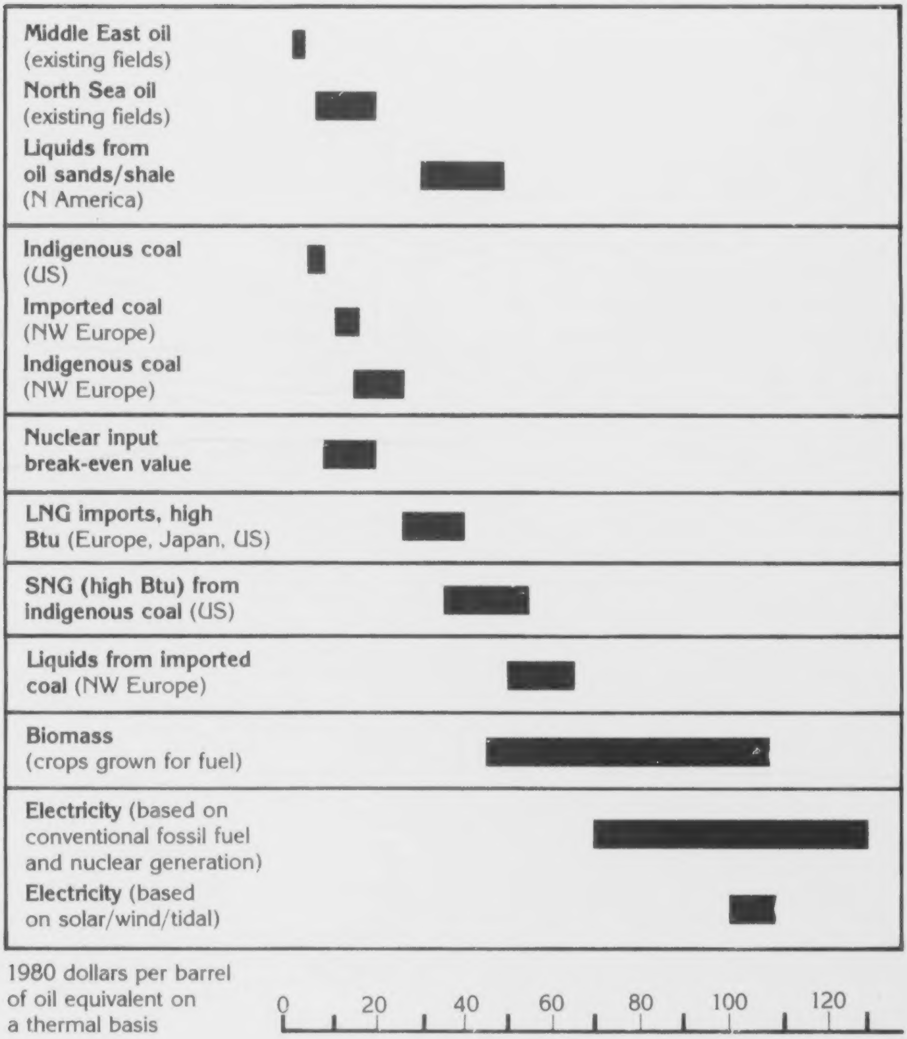
Improving Market Signals

We start from the proposition that if short-term supply and demand price inelasticity produces oil price swings between, say, $15 and $75 per barrel, investment will be unnecessarily held back by such extreme volatility and the expectation that it could continue. At present, it appears that in the

Figure 1

Estimates of Comparative Energy Costs[1]

■ Estimated range



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[1] Thermal equivalence is not the only basis for comparing different energy sources. Efficiency losses in the systems used to translate thermal energy to usable work affect the end-use costs of alternate energy sources.

Source: Royal Dutch/Shell Group, *The Energy Spectrum*, Shell Briefing Service Number Three, 1982, p. 3.

future the real price of oil should rise gradually, to make commercially feasible the production of other more costly sources of energy. Figure 1 indicates the basis for this judgment. But to the important point in that we do not need to claim to know what the "right" real price is or will be, in order to make the case for greater stability.

The first difficulty is that it is in the short-term economic interest of the oil importing countries that real oil prices continue to decline. Falling oil prices reduce inflation, improve the balance of payments current account and stimulate recovery from recession.[2] But this short-term interest conflicts with the long-term economic interest in effecting a smooth transition from the present energy regime which still reflects the historic reliance on low-cost energy sources, to a future one likely to be based on higher costs. The short-term interest in falling oil prices also conflicts with the political interest in ensuring that oil exporting countries, especially those in the Gulf region, enjoy the political and economic stability which flows from stable oil revenues.

For the oil exporting countries the conflict between short-term and long-term interests occurs when oil prices rise rapidly, as in 1979-80. The short-term financial gain obscures these countries' long-term strategic interests in the economic and political health of the Western industrialized countries and in insuring a continuing market for oil.

These conflicts in interest make it difficult for either side to act in pursuit of long-term interests when opposing short-term interest is rewarded by the market at the moment. Moreover, as argued above, the structure of the oil market is such, and the forces within it are strong enough to prevent either oil exporting or oil importing countries from stabilizing the market by themselves. Both parties must act, by taking steps which strengthen long-term interests, do not penalize short-term interests, and improve the resilience of the market.

When real oil prices are declining because of falling demand nothing can substitute for the ability of the OPEC countries to coordinate a curtailment of production. Because so much of the value of Middle East oil is economic rent, the danger in a soft oil market is downward price competition unbuffered by the cost of production.

Better Stockpile Management

However, oil importing countries also should play a constructive role. True, they do not have a short-term interest in helping the OPEC countries defend their oil price structure, but they do have an interest in ensuring that oil stockpile management is economically sound. This means, among other things, acquiring more crude oil and product stocks when the market is soft and releasing them when the market is tight. Both actions help OPEC countries moderate severe oil price movements and are in the long-term *and* short-term interests of the industrialized oil importing countries.

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[2] Assuming that the financial problems of heavily indebted oil-exporting developing countries ca be managed without impairing further the stability of the international banking system.

The oil market will be capable of resisting price explosions if it is resilient enough to absorb unexpected supply disruptions. Since oil demand fell in 1981-83 OPEC countries now have spare production capacity of more than 10 MBD. This in itself is a powerful buffer in the current oil market, but it is not the result of explicit policies and could change quickly. In this case there is no substitute for proper stock management policies on the part of the industrialized oil importing countries.

Although the world now maintains a controllable inventory of oil (and its products) of between 1.0 and 1.5 billion barrels, the record since 1973 of stock management as a buffering influence in the oil market has been for the most part dismal. Stock drawdowns in 1975-78 and in 1981-82 exacerbated the decline in real oil prices, and stock buildup in 1979 and mid-1980 contributed to the explosive price increases.

In the oil market, politics and economics tend to work perversely with respect to stockpile management. Governments find it difficult to maintain domestic support for acquisition of strategic stockpiles, especially when the oil market is slack — though that is when stocks should be acquired — since there is unlikely to be a public sense of urgency. On the other hand, when a crisis disrupts some portion of supply in a tight market, governments — not knowing how long the crisis will last or whether it will get worse — tend to increase stocks rather than draw them down.

When interest rates are high, industry stock management behavior in the oil market tends to be perverse as well. In a tight oil market, expectations of big future price increases make increased stocks prudent and financially feasible, despite high interest rates. Thus it made good business sense for the industry to increase stocks in the fall of 1980 after the war between Iraq and Iran began, even though spot prices were rising. Similarly, it made no sense to retain excess stocks in 1981 and 1982 when real oil prices were falling, interest rates were high and the annual cost of carrying the stocks was 25 percent of the oil price. In both instances government and industry stock management behavior exacerbated swings in the oil market.

The OECD/IEA International Emergency Program (IEP), which calls for sharing of oil stocks and surpluses among IEA countries in the event of an emergency disruptions, does not deal satisfactorily with buffer stock issues. Aside from questions about whether the Program would work in practice, its trigger (7 percent supply loss) is set too high to enable the sharing scheme to operate as a price buffer in a tight but otherwise normal market. Moreover, the Program has no provision for price support in a slack market.

Four improvements in oil stock management policies would contribute to market efficiency and stability:

First, the OECD countries should establish stock management policies which will permit the coordinated acquisition, maintenance, and proper use of strategic stocks, adequate to cope with a substantial emergency disruption of oil supply. One necessary element of this strategy is a clear separation between industry stocks and government financed and owned strategic stocks.

Second, OECD governments should adopt policies which provide incentives for their oil companies to acquire extra commercial stocks when the oil market is soft and release them when the market is tight. One such incentive is a guarantee by government that industry stocks will not be confiscated in circumstances short of a dire emergency.

Third, in the early stages of a supply emergency — when it is not clear whether or not the interruption is temporary — OECD governments should allow industry to reduce mandatory commercial stocks somewhat (say, 85 days rather than 90), allowing stock trading and to reduce pressures on the spot market.

Fourth, OECD governments should design contingency policies and procedures for making decisions to enter a stressed oil market by selling strategic oil stocks. Only a few governments have thought through the puzzle of how, whether and when strategic oil stocks should be used for price stability in an emergency.

A more general proposition is that demand and stockpile management should be structured so that they are compatible with market conditions (which is in the interest of both oil importing and oil exporting countries). OECD countries should discuss with OPEC countries stock and demand management policies and surplus production capacity policies, to build confidence in the ability of the two sides to enhance their common interests. Unfortunately there does not exist an obvious institutional channel of communication, and the IEA is an unlikely candidate.

The IEA and its emergency programs were established in 1974 in an atmosphere of fear about the "oil weapon" and so have been seen as an instrument of confrontation with OPEC. It is partly for this reason that France is not a member of the IEA. It is possible that the OECD Oil Committee and the OPEC Long-Term Strategy Committee might provide a useful institutional channel for consultation.

Improving the Economic Functioning of the Oil Market: The Financial Side

There are two related but conceptually different issues involved in improving the economic performance of the oil market from the financial side:

> Enabling economic adjustment by the oil importing developing countries to take place efficiently without placing excessive strains on their economies and on the international monetary system;
>
> Removing barriers to investment of surplus oil revenues so that surplus oil producing countries retain an economic incentive to produce oil when demand is strong and can efficiently acquire assets which will enable them to curtail oil production when oil demand is weak.

A full discussion of the first issue is beyond the scope of this report. In brief, though, a principal concern is to ensure that the oil importing developing countries are permitted opportunities to devise appropriate mixtures of adjustment policies and financing which permit a politically bearable transition to sustainable economic positions, given changes in energy and other import prices, and slower growth in export markets. A key issue is concessionary lending requirements, and here it is important to categorize oil importing countries' problems carefully.

One group, though not members of OPEC, can expect to be oil exporting countries and therefore are not critically in need of concessionary financing for energy purposes. A number of countries have joined, or are expected to join, the ranks of this group: Angola, Bahrain, Bolivia, Brunei, Burma, Congo, Egypt, Mexico, Malaysia, Oman, Peru, Syria, Trinidad and Tobago, Tunisia, and Zaire. These countries have opportunities for development strategies based on oil exports totaling in 1978 1.74 MBD — opportunities not available to the other 80 or so oil importing developing countries.

But this group of 80 countries, too, needs categorization. Nine of the 80 countries import more than 100,000 barrels per day, and at 3.17 MBD in 1978, accounted for 77 percent of the total net imports of all oil importing developing countries: Brazil, South Korea, Turkey, Taiwan, India, the Philippines, Thailand, Cuba, and Singapore, in descending order of imports. But of this group, India in 1979 had a per capita income of $190 and the Philippines $600; the other seven had per capita incomes above $1,000.[3]

Among the other 71 countries, oil imports totaled 920,000 barrels per day in 1978. But their economic fortunes varied widely, from Bangladesh, importing 36,000 barrels per day in 1978 and with a per capita income of $90, to Argentina, importing only 25,000 barrels per day in 1978 but with a per capita income of $1,910. In 1978, Argentina imported less than one quarter of India's oil imports, but its per capita income was more than 10 times that of India.

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[3] *World Development Report, 1981, op. cit.*, pp. 134-135.

The moral of the story is that the problems of the developing countries are the most serious candidates for humane management of the recycling process. But within this group, the problems are vastly different. Among the nine developing countries which accounted in 1978 for three-quarters of developing country imports, the problem for all, perhaps excepting India and the Philippines, is whether they are overextended in commercial lending markets. For the 71 small importers the question is differentiating between poverty and smallness. Of the 71 small importers, 63 had 1978 income per capita figures below $1,000; their collective 1978 oil imports amounted to about 560,000 barrels per day — at 1983 prices of, say, $30 per barrel, a total of $6 billion. Adding the oil import bill for India and the Philippines, the total requirement for financing of oil imports would be about $12 billion per year in 1983 dollars. Some portion of this should be concessionary, and this is well within the range of the OPEC/World Bank/International Monetary Fund/OECD capabilities for, broadly speaking, short-term structural adjustment lending to these countries, if properly organized. But it is not yet clearly so organized.

This problem came into urgent focus in late 1982 as the prolonged recession made it increasingly difficult for many oil importing developing countries to service their international debt. Ironically, the decline in oil demand and real oil prices has also placed a number of the oil exporting countries in financial difficulty, compounding strains on the international monetary system. Action is being taken to cope with these emergency circumstances (e.g. by increasing the resources of the IMF). But the financial problems of several large developing countries are likely to persist for much of the decade, and further action of a more radical nature may well be required.[4]

Removing Investment Barriers

The second issue — removing barriers to surplus oil revenue investment — is at once more straightforward and more challenging. From 1974 to 1979, investment of surplus revenues (that is revenues from oil production of some countries — typically Saudi Arabia, Kuwait, U.A.E., Iraq, and Libya — above what they needed to finance domestic development and import requirements) sometimes failed to produce a real financial return, or produced a real return less than that which might have been realized from keeping the oil in the ground.

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[4] For one suggestion, see *IMF Borrowing in the Private Markets* Group of Thirty, 1983.

High real interst rates in the United States since 1979, and weak oil prices in 1981-83 have reversed this trend. But the issue could return.

During the period 1975-78, real oil prices fell, and investing surplus revenues in the economic recovery of the West and growth of the newly industrializing countries made very good financial sense. The second oil price increase of 1978-80, however, shifted the risk/return calculus in favor of oil in the ground. It became very difficult for surplus oil exporting countries to justify, domestically, excess production of a very attractive asset — oil in the ground — for financial assets which might yield a negative return in view of inflation rates, but in any case could almost never compete with the discounted future value of oil reserves.

The decline in oil demand after 1979 introduced a new factor into the decisions facing the surplus oil exporting countries. Recently most of these countries have encountered balance of payment deficits, requiring them to draw down financial assets and curtail imports. If the oil market in the future presents the surplus oil exporting countries with wide swings in demand, they will have to devise oil export and domestic economic development strategies which will permit them to acquire substantial financial assets when oil demand is high. In support of such strategies it will be important for the oil importing countries to enhance the opportunities for investment.

The first and obvious step is to remove barriers to investment in a broader range of assets available in oil importing countries. In the past it has been difficult for Arab oil producing countries to invest in certain kinds of real assets in some oil importing countries. No doubt this difficulty stemmed from concern in the oil importing countries about adverse public reaction. But the fact is that OPEC surplus oil producing countries have demonstrated that they are responsible and careful investors, respectful of national interests in the host countries and interested in financial return from, rather than control of, the assets in which they invest.

In the developing countries attracting surplus oil exporting country investment funds directly could be more difficult initially than attracting funds from the industrialized countries. But here too removal of domestic rules inhospitable to oil producing country funds will speed the flow of OPEC capital to developing countries and balance the investment portfolios of the surplus oil exporting countries. Moreover, it is evident that the flow of new bank lending to many developing countries has been sharply curtailed and may not quickly recover, so that they now have a strong incentive to attract funds directly from investors.

All oil importing countries are advised to review their tax treatment of surplus oil country exporting investments. Sovereign tax immuunity improves the return from host country investments. Unfortunately it usually results from negotiated reciprocal tax treaties; many surplus oil exporting countries do not tax commercial activity domestically and thus cannot offer reciprocal tax benefits to oil importing countries. But this is surely no more than a problem of negotiating jurisdiction: tax immunity in the oil importing countries might be granted in exchange for something else of value in the surplus oil exporting countries.

In the spirit of reducing financial market distortions and barriers to efficient recycling, it should be noted that seizure of financial assets for political reasons inevitably chills the financial markets. It breeds a kind of financial equivalent to trade nationalism, and should be broadly disavowed.

Conclusions

Past history has produced a climate of suspicion and occasional confrontation between oil importing and oil exporting countries — hardly a promising context within which to create the collaborative arrangements and confidence-building measures described here. Yet the critical importance to the world of the international oil market and the defects in its current structure and functioning will be of concern for the remainder of the decade and probably beyond. International anxiety about the oil market's structural defects itself could be a threat to the stability of the oil market.

From this analysis it is difficult to envision effective improvements in the structure and functioning of the oil market which do not involve some collaboration between oil exporting and oil importing countries. Indeed, it is the fact of collaboration itself, and the conditioning of expectations which it engenders, that constitute the main thrust of the considerations set forth here. Unilateral measures taken by either oil importing or oil exporting countries alone may not reach the structural problems identified, and could worsen them if matched by a confrontation response by the other side.

Collaboration, on the other hand, need not mean a formal agreement — still less a "planetary bargain." It is hard to see how such an agreement could be reached, even if desirable, given the existing climate and the formidable political difficulties involved in all multilateral negotiations. A more promising approach may lie in the prospect that many of the suggestions outlined here might require only tacit agreement that national policies and international arrangements which are compatible, are desirable for all parties. Measures to improve the functioning of the oil market, for example in stock management policies, do not require irreversible steps on the part of one party which, in the event of apparent bad faith on the other side, might appear undesirable. The value and durability of such tacit arrangements can be tested over time. Financial facilities to assist developing countries, such as those currently under negotiaton to increase the resources of the IMF, do require formal arrangements, but perhaps at less political cost or risk than matters dealing with the price and availability of oil at least in this field of international relations the machinery of cooperation is well-established — what has been lacking is the will to use it to the full.

In summary, it is desirable and may be feasible to construct arrangements among oil importing and oil exporting countries which would improve functioning of the oil market. This notion does not yet have widespread acceptance in either oil importing or oil exporting countries, though the outlines of it could quickly emerge in the right circumstances. The danger is that either a collapse in oil prices or a new emergency could arrive very quickly — well before widespread acceptance of the need for cooperation and its modalities exists and enables governments in both oil exporting and oil importing countries fail to cope with it, the resulting political and economic damage and the ensuing bitterness will make it far more difficult for cooperation to flourish thereafter. On the other hand, successful cooperation now, even if limited, will establish the atmosphere and confidence that can permit more cooperation in the future.

Appendix 1

The Effect of Exchange Rates on Oil Prices

Edwin A. Deagle, Jr.

The fact that oil sold worldwide is generally priced in U.S. dollars means that delivered energy prices in countries other than the United States are partly determined in foreign exchange markets. When the dollar falls relative to other currencies, oil prices in those countries fall proportionately. When the dollar rises relative to other currencies, oil prices rise also. The tendency in foreign exchange markets to witness wide swings in the value of the dollar means that major shifts in oil prices can occur. Table I illustrates how currency fluctuations have boosted European and Japanese oil costs between 1980 and 1982.

It is difficult to know whether major changes in oil prices have an important influence on exchange rates, especially dollar rates. A substantial decline in oil prices in 1983, for example, would reduce the demand for dollars to clear international oil import accounts. This might bring downward pressure on the dollar exchange rates. But other forces related to economic recovery and to government policies could prove more important.

Table I

	Dec. 1980	Oct. 1981	Sept. 1982
Weighted Avg. OPEC Price	$32.90	$34.40	$32.95
Real Local Cost*			
United States	32.90	32.60	30.62
Japan	32.90	37.22	39.86
Germany	32.90	36.53	37.00
France	32.90	38.13	41.81
United Kingdom	32.90	39.63	38.25
Italy	32.90	38.30	39.65

* Local average currency cost adjusted for inflation and expressed in 1980 dollars.
Source: *Petroleum Intelligence Weekly*, October 4, 1982, p. 2.

Appendix 2

Note on Availability of Non-Oil Energy Supplies

Bijan Mossavar-Rahmani[1]

Two dramatic oil price increases and perceptions of insecurity of foreign oil supplies have provided the stimulus for stepped-up production and utilization of alternative energy sources in recent years.

Until the early 1970s, consumption of oil was growing at a rate much greater than that of all energy; by 1973, oil consumption comprised more than half of the total non-communist world (NCW) primary energy consumption. In the post-1973 period, however, the NCW energy mix has undergone a significant, and in all likelihood, lasting shift; oil consumption has grown at about 2 percent a year (as compared to nearly 8 percent before 1973) and its share of the total is expected to decline just over 40 percent by the end of this decade.

Coal

Coal, in turn, is projected to make particularly strong gains. In addition to meeting a growing share of new energy demand, coal is expected to replace oil in major industrial and utility markets. Between 1980 and 2000, NCW coal consumption is projected to increase from 20 million barrels a day of oil equivalent (MBDOE) to about 40 MBDOE. The conversion of coal to synthetic liquids and gases will not become significant until the end of the century, given the current investment climate and the long lead times for these projects. However, higher oil prices have made international trade in steam coal increasingly viable, and according to estimates, seaborne coal trade could quadruple between 1980 and 2000 to almost 8 MBDOE. The United States will remain the world's largest producer; the greatest constraints on coal output and use will continue to arise from environmental considerations.

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[1] Member, Harvard Energy Security Program; Doctoral Candidate in Politics, Economics and Government at Harvard University.

Table I

NCW Primary Energy Consumption

(MBDOE)

	1970		1975		1980	
	MBDOE	(%)	MBDOE	(%)	MBDOE	(%)
Oil	39.5	(51.3)	45.2	(52.9)	49.0	(50.6)
Natural Gas	14.7	(19.1)	16.1	(18.8)	17.6	(18.2)
Coal	17.1	(22.2)	16.4	(19.2)	20.1	(20.8)
Hydropower	5.3	(6.9)	6.2	(7.2)	7.1	(7.3)
Nuclear	0.4	(0.5)	1.6	(1.9)	3.0	(3.1)
Total	77.0	(100.0)	85.5	(100.0)	96.8	(100.0)

Source: Adapted from British Petroleum (1981).

Table II

Projected NCW Primary Energy Consumption

(MBDOE)

	1990		2000	
	MBDOE	(%)	MBDOE	(%)
Oil	53	(43.4)	54	(34.6)
Natural Gas	23	(18.9)	26	(16.7)
Coal	22	(18.0)	40	(25.6)
Hydropower	8	(6.6)	10	(6.4)
Nuclear	11	(9.0)	15	(9.6)
Synthetics	3	(2.5)	7	(4.5)
Renewables	2	(1.6)	4	(2.6)
Total	122	(100.0)	156	(100.0)

Source: Adapted from Exxon (1981).

World natural gas consumption is expected to show steady growth over the next two decades in absolute terms, with most of this growth occurring in Japan and those developing countries with indigenous reserves. Substantial natural gas deposits have already been discovered in Latin America, North Africa, the Far East, as well as in the Middle East, which could support stepped-up regional and international trade. However, the natural gas export market is largely undeveloped because of the high cost of long-distance transportation, particularly where gas has to be processed for shipment in liquified form. Another important barrier to increased trade in natural gas has been consumer concern over added dependence on foreign sources of fuel supplies.

Nuclear Energy

The share of nuclear energy in total energy supply will increase during the 1980s, albeit at a lower rate than previously projected. Currently, more than 200 power plants are in operation in the NCW region, providing about 3 percent of total primary energy supply; this share is expected to double by 1985 as reactors now under construction begin operation. But the longer-term prospects for nuclear power have become more blurred as a consequence of growing public concern over safety hazards, environmental risks, waste disposal, nuclear weapons proliferation, and a changing cost picture. In one country, the United States, stringent regulations have stretched out the time needed to build nuclear plants to about 12 to 14 years. The International Atomic Energy Agency has recently estimated that after 1985, construcion work on new reactors outside the centrally planned economies will be less than 5 gigawatts-electric a year as compared to more than 10 gigawatts-electric a year between 1981-1985. Existing and planned uranium supply and enrichment capacity will be adequate during this period, and are thus not expected to constrain nuclear growth if and when political attitudes towards this souce of energy become more favorable.

Synthetic Fuels

Synthetic fuels — liquids and gases that can be derived from coal, heavy oil, oil sands, shale oil, and agricultural products — can make a growing contribution to world energy supplies, particularly as substitutes for conventional oil products and natural gas. Although subject to many uncertainties, synthetic fuels could provide as much as 3 MBDOE by 1990, growing to 7 MBDOE by 2000. These estimates are technologically feasible, but are highly dependent on government policies and regulations relating to environmental protection and access to resources. Moreover, as most processes are very costly and have yet to be demonstrated in plants of commercial size, substantial government commitment and at least initial financial support are prerequisites to the establishment of synthetic fuels industries. Because of its vast coal and oil shale deposits, as well as its technological and financial capabilities, the United States has the greatest potential for the production of synthetic fuels, and its policies will influence the rate of development of synthetic fuels elsewhere. Other countries with major potential include Canada, Venezuela, Brazil, and Australia.

Renewable Resources

With the exception of hydropower, renewable energy resources will not become significant in the next two decades. Hydropower currently provides about 7 percent of total NCW primary energy consumption; future growth in output will be concentrated primarily in a few sites with relatively large capacity in Latin America and Canada. The total contribution of other renewables, notably solar energy, direct biomass (including wood wastes, firewood, and crop residue), alcohol fuels from biomass, and tidal, wind, and wave energy is projected to increase from more than 1 MBDOE to almost 4 MBDOE or some 2 percent of the total by 2000. Ultimately, the two most promising sources of renewable energy — nuclear fusion and photovoltaic electricity — may make substantial contributions to world energy supplies, but the prerequisite technical and cost breakthroughs are not expected to take place before the end of the century.

Appendix 3

Oil Stockpile Management and the Stability of the World Oil Market in the 1980s

Edward N. Krapels[1]

It is ironic that stockpiles of crude petroleum and refined products have become an unsettling force in the relationship between oil exporting and importing countries. In 1973-74, and again in 1979, the management of global stocks put upward pressure on prices. In contrast, from 1975 to 1978, and again in 1982 and early 1983 the management of stocks exacerbated downward pressure on prices. These swings in price were regarded as crisis to those on the losing side, and as victories of a sort to those on the winning side of the trend.

The irony rests in how at odds this unsettling role is with the ideal role of stockpiles, one in which properly managed stocks remedy price instability in the world oil market. Economists have long recognized that buffer stock programs set up by importers and exporters of an internationally traded commodity can operate to the advantage of both groups in the long run. In principle, a buffer stock can prevent the need first for importers and then for exporters to adjust to large losses in (planned) income forced on them by drastic and unforseen swings in the commodity price or revenues. In practice, a buffer stock program requires scarce inputs like political cooperation between exporters and importers to set it up, and sufficient wisdom on the part of the stock administrators to sell and to buy at the right time, in the right quantities and at the right price.

There are numerous reasons why even the first requirement — sufficient political cooperation — is absent. Stocks are a manifestation of the dearth of goodwill between exporters and importers, and simultaneously one of the chief obstacles towards an improvement in that relationship.

The extremely high level of oil stocks held recently and the well-publicized plans of the United States, Japan, and others to acquire substantially more oil for strategic stocks in the years ahead are signs of the industrialized countries' lack of confidence in the stability of oil trade. During 1981, the member-states of the International Energy Agency (IEA) had on-land stocks averaging 300 to 500 million barrels more than historic levels.[2] At today's prices, this cushion represented tied-up capital of up to $16 billion. At U.S. prime interest rates near 18 percent, the carrying cost alone on this oil was $240 million per month.

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[1] Energy Security Analysist, Washington, D.C.

The sheer magnitude of consumer stocks is understandably provoking some anxiety among oil producers, especially the oil exporters able to put all their oil revenues to immediate use. By the end of 1981, oil exporting countries could not be blamed for believing that the emergency stocks of importing countries would be (and perhaps since have been) used to fight OPEC pricing decisions. To make matters worse, stock drawdowns (like the embargo directed against the United States in 1973-74) can in principle be targeted against particular exporting countries. In this case, the OPEC members losing market share will put pressure on other producers for help.

A question of policy is whether governments can progress from the current situation in which stocks are a destabilizing force in world oil trade toward a situation in which stocks are managed in a way that contributes to orderly conditions in the world oil market. If this search is not to wander into abstractions, it must take as given the many extraordinary features of the world oil situation: the sheer indispensability of world oil trade, the changing commercial structure of the world oil market, importers' need for supply security and cost stability, and exporters' need for revenue stability. These and other features determine the need for pragmatic measures. A constructive approach is to orient the policy search around confidence-building measures. Oil exporters and importers can explore stock management policies that will erode the climate of suspicion that exists. To do so, it is useful first to look briefly at the experiences that have led to the present state of affairs.

International ~~Oil~~ Stocks in the 1970s

Most importing countries entered the 1970s with poorly developed oil storage programs, and even more crudely developed ideas about how to use the stocks they had on hand. After the oil crisis of 1973-74, the attention of most legislators was on how to finance and administer stock programs. The key issue for most governments was how to design regulations that imposed an equitable burden on the various types of oil companies in the market.[3] Very little effort was expended, at least on the national level, on designing a drawdown strategy.

In the course of the decade, most of the countries joining the

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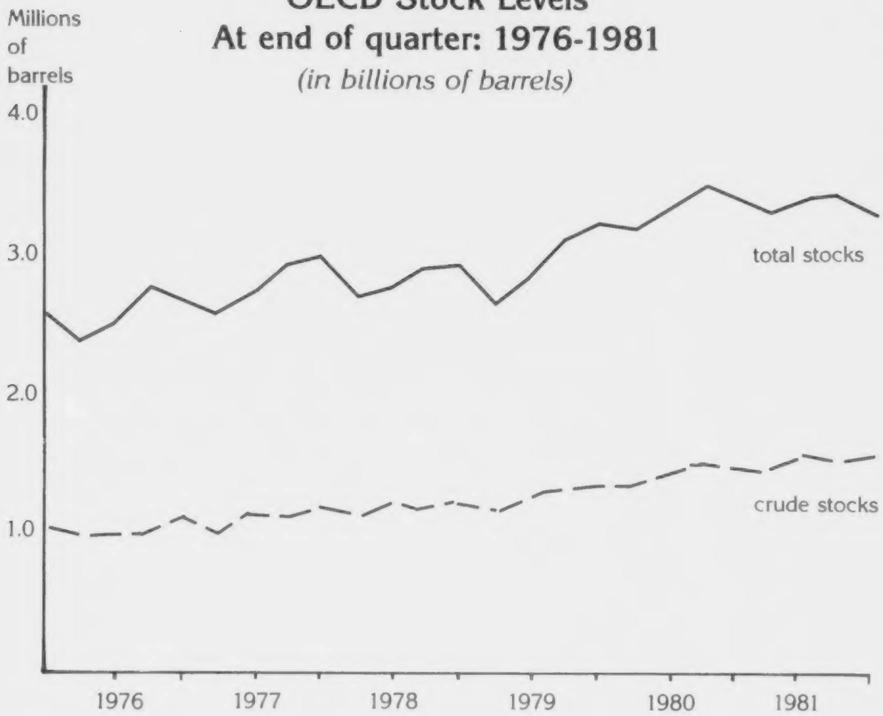
[2] IEA country oil stocks amount to about 3 billion barrels, while world stocks average about 10 billion barrels. See pp. 00-00 in text of Report.

[3] Companies that imported only finished products argued that imposing the same 90-day obligation on them as on refiners was unfair: refiners must hold proportionately larger

Figure 1

OECD Stock Levels
At end of quarter: 1976-1981
(in billions of barrels)



International Energy Agency in 1974 took steps to comply with its requirement for the maintenance of an emergency stock equivalent to 90-days of the previous year's net imports. There were, however, two prominent exceptions to the 90-day trend: the United States and Japan set much higher stock goals.

For a well-documented variety of reasons, the United States was particularly unsuccessful in meeting the storage objectives it set in the mid-1970s. By the end of 1980, according to the initial plan released in December 1976, there should have been 325 million barrels of government-owned crude in the Strategic Petroleum Reserve (SPR). Instead there were only 100 million barrels. By the end of 1982, however, the active stock-building policy of the Reagan Administration had resulted in a rapid increase in the SPR size to 300 million barrels. Japan was more successful. It set out to acquire 63 million barrels for government storage (actually, Japan National Oil Corporation has been the agent) by 1982. As of the middle of 1982, about 70 million barrels were in place, stored in idle tankers anchored off the coast. Another 113 million barrels are to be acquired by 1985.

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operating inventories than product importers, hence the real cost of a 90-day requirement would be far larger for the product importers.

In spite of their impressive ultimate objectives and scope, neither the American nor the Japanese program made an important impression on the world-wide oil supply and demand pattern in the 1970s. Insofar as stock movements did affect world oil trade and prices, the inventory management of the oil companies was of far greater import than the strategic stock moves of governments.

Figure 1 illustrates the development of OECD total inventories (crude oil and finished products are combined) and of crude stocks only during the period 1975 to 1981. Total stocks fluctuated between a low of 2.4 billion barrels at the end of the first quarter of 1976 and a high of 3.5 billion barrels at the end of the third quarter of 1980.

These rough-grain data obscure, however, the very sizeable impact that changes in stock levels can have on the *flow* of the world oil. Figure 2 provides a view of daily average flows of oil into and out of the OECD stocks on the basis of the quarter-end stock data. As noted, stock drawdowns at a quarterly average rate of 3.85 MBD occurred in the first quarter of 1978, a flow equivalent to the production of several OPEC states. One must be careful not to take an exaggerated view of the impact of these stock swings on international oil trade.In fact, about 2 million MBD of the 3.85 million MBD stock drawdown can be attributed to an unusually heavy demand for heating oils in the first quarter of 1978. Crude oil stock drawdowns, which obviously reflect more directly the need for oil from exporting countries, averaged only about 0.215 MBD in the first quarter of 1978.

Crude oil stocks fluctuate with less regularity and depth than total stock levels. The most consistent pattern for crude in Figure 2 is the trough at the end of the first quarter. This results principally from the oil companies' tendency to sell off that quantity of oil that may have been acquired for speculative purposes just prior to the December OPEC meetings. Aside from this modest aberration, it is the small fluctuations in crude stocks that can be seen as representing the industry's collective inventory strategy from 1974 to 1979.

That strategy seems during this period to have been to keep crude stocks at an even keel. There was a slight upward trend in crude stock levels, as evidenced in Figure 1. In 1976, quarter-end stocks averaged 1.065 billion barrels and 1.192 billion barrels in 1978.[4] The growth in the U.S., Japanese, and West German *government* stockpiles, however, accounted for most of this gradual increase.

In retrospect what seems surprising to many is why there was not an

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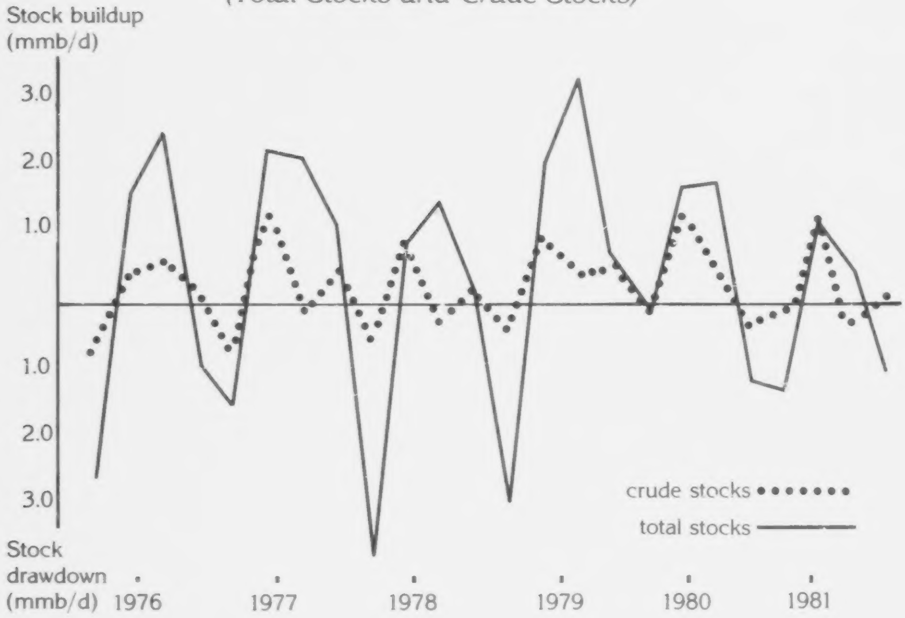
[4] Refinery throughput surges occur in the fourth quarter, not in the first. Hence, the sharp drop in crude stocks in the first quarter cannot be attributed to higher throughput. The speculative stockpiling theory given above is supported by the fact that OPEC production has almost always fallen in the first quarter.

Figure 2

OECD Stock Drawdown & Buildup

(Total Stocks and Crude Stocks)



incentive for companies to keep much higher stocks. Essentially, of course, the reason must be that oil companies did not find it profitable to do so. During soft markets, the so-called obligatory stock levels generally required by governments (with the outstanding exception of the United States) are viewed as major financial millstones by the companies. For example, the industry fought the German government for years in the courts to prevent higher storage obligations. In the United States, company spokesmen time and again argued against any suggestons that the government mandate any storage requirement on them.

The source of this resentment was the widespread and persistent softness of product prices during the 1975-78 period. In many countries, retail prices not only did not rise enough to keep up with inflation, they fell in absolute terms.[5] Product spot market prices in 1976 and 1977 were rock-steady. Gas-oil prices (FOB Rotterdam), for example, were between 110 to 130 dollars per metric ton during this entire period. In contrast, in 1979 the range of gas-oil spot prices was 150 to 390 dollars per metric ton.

During the 1975-78 buyers' market, the inventory management practices of the oil companies could have confronted OPEC with a far more serious supply planning problem than they actually had. A deliberate and sustained drawdown of stocks in early 1976, when OPEC production was down to 25 million barrels per day, might have put pressure on some OPEC countries to discount prices even more than they did.

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[5] For example, in Japan the wholesale price of gasoline fell in 1978 from 105 to 98 yen per liter.

Figure 3 suggests that a deliberate consumer drawdown might have had quite a strong impact on OPEC in the first quarter of 1977 or 1978. In the wake of the December price meetings, demand for OPEC oil declined sharply (5 MBD for a month or two before recovering.) To explore what impact a deliberate stock drawdown policy might have had, assume that in 1977, due to the split in OPEC pricing policies, consumers decided to draw down stocks in a way that was targeted on the OPEC price "hawks," in this case all members save Saudi Arabia and the United Arab Emirates. The production by the price hawks was 23.2 MBD in December 1976. In January 1977 it fell by 20 percent to 18.6 MBD. In February their output recovered to 20.5 MBD, in March to 21.2 MBD.[6] Now suppose that, in order to demonstrate their displeasure with the price increase, the importing countries had decided to reduce their demand by an amount sufficient to maintain the price hawks' 20 percent loss in sales in January. Assuming that consumer demand is adequately represented by the above-mentioned sales figures for February and March, the importers would have had to draw down their stocks by 1.9 MBD in February and by 2.6 MBD in March. That would have been a total stock draw of 134 million barrels. That amount, in

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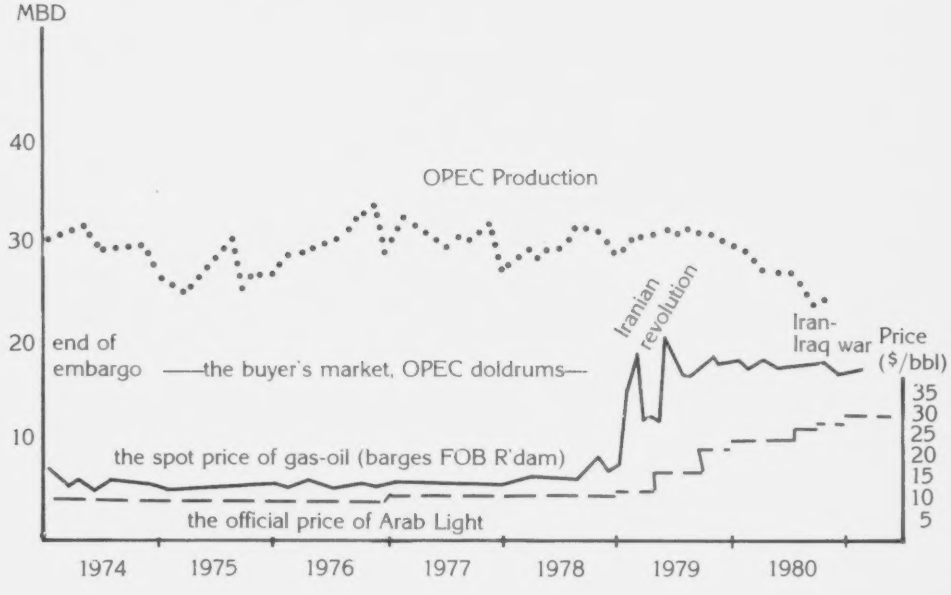
[6] Figures from *The Petroleum Economist*, November 1977, p. 461.

Figure 3

OPEC Production, OPEC Price, Spot Price: 1974-1980



turn, would have been equivalent to approximately four days' worth of OECD imports. Assuming the importing countries believed they had ample stocks to begin with, a drawdown of four days' worth of imports to keep pressure on the exporters for 60 days may have seemed worth the cost.

Of course, this or any other drawdown was not considered because governments of importing countries did *not* believe they had ample stocks to begin with. The rather small emergency reserves most countries possessed were deemed to be too important to be used in anything short of a major disruption. Hence, there is something to the notion that the importers' own storage policies, and attitudes, helped the oil exporters maintain oil prices during the 1975-78 buyers' market. Producers can have no assurance, however, that a better-stocked, more confident group of importing countries will not use stocks in the way described above in the future.

International Oil Stocks from 1979 to 1981

One of the reasons consumers may be more confident about using stocks for price-control purposes in the future is that they have been through one crisis that demonstrated the consequences of not using stocks for price control, and one which seems to have demonstrated that stocks can be used for price control purposes.

The international oil supply disruption touched off by the revolution in Iran brought home to governments of importing countries that they had no practical plan for using the emergency reserves that had been maintained or accumulated since the Arab oil crisis of 1973-74. As already mentioned, the oil companies were maintaining inventories at levels near minimum operating requirements (in the United States and Canada) or minimum obligatory levels set by government (Europe and Japan). By the second half of 1978, industry crude stock levels were probably lower than in the second half of 1976 or 1977. Hence, the cessation of Iranian exports occurred at a point when industry inventories were anything but flush. As a consequence, throughout 1979 companies appeared to be orienting their purchases not at *maintaining* stock levels, as was their strategy in the 1975-78 period, but at *building* them up. Although this is absolutely understandable from the firm's point of view, it was not good state policy, because it created a demand for stocks, a "shadow demand," as it were, that put great upward pressure on oil prices in the open markets.

The first signs of pressure came, as expected, from the spot market for finished products in Europe. As Figure 3 indicates, the price of gas-oil, the most important product volumetrically, reached $45 per barrel in February. Spot crude prices, according to the *Petroleum Intelligence Weekly*, followed the more volatile product quotes. Arab light, whose official sales price was $13.34 until April and $14.55 until June, was sold in the spot market for $15.95 in January, $19.50 in February, $20.80 in March, $21.20 in Apirl, $34.25 in May, until finally breaking in June at $32.85[7]

Given the scale of these increases, oil companies could easily figure the benefits of increasing inventories in preparation for the increase in official OPEC prices that everyone was certain would come. In these circumstances, there was virtually no incentive to draw down stocks. To the contrary, there were strong incentives to build up stocks; and that is what some companies did. After years of trying to minimize stock levels, oil companies went on an unprecedented buying spree, as Table 1 shows.

There are, no doubt, many reasons for the dramatic increase in stocks that began in the third quarter of 1979 and continued through the third quarter of 1980:

1. Oil companies everywhere underestimated the decline in demand that accompanied the increase in oil prices in 1979. Yet that factor alone is insufficient, because such a miscalculation could have been corrected in the first quarter of 1980. To the contrary, Table 1 indicates that stocks continued to climb in that quarter.

2. The industry's confidence in the security of its oil supply deteriorated. It should not be surprising that those companies that had been accustomed to receiving their crude oil from Exxon or British Petroleum and had now to buy from the National Iranian Oil Company (NIOC) would be prone to carry high safety stocks while getting acquainted with their new supplier. Perhaps this explains best the very large increase in Japanese stocks, because Japanese firms were in the front of the queue at NICO's door.

3. Simple speculation. Companies were willing to gamble that the OPEC price hawks would succeed in forcing Saudi Arabia to increase its official sales prices in the second half of 1979, thus providing companies with inventory profits. In addition, investments in inventory provided a shelter against the extraordinary profits that some companies were earning.

4. Building large inventories was not only a good investment in the climate of 1979 — because a substantial increase in official prices seemed inevitable — it was also good politics. Holding large inventories, in effect, was not only the result of a miscalculation of the demand response to higher oil prices, it was economically, politically, even strategically advisable in 1979. In 1980, some of these conditions changed.

In early 1980, a number of signals pointed to more normal stock maintenance by the oil industry. First, prices in the spot markets steadied. Gas-oil quotations in Rotterdam stabilized around the $300 per metric ton ($40 per

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[7] *Petroleum Intelligence Weekly, April 21, 1980.*

Table 1

Industry Crude Oil Inventories in Selected Countries: 1979 Through 1981

(millions bbls)

	United States[1]	Japan[2]	France	West Germany[3]
January 1979	302.7	187.1	59.6	76.9
March	317.4	186.2	55.6	78.5
June	325.9	190.3	71.6	81.6
September	323.9	188.8	67.3	97.1
December	339.1	216.2	66.4	95.4
March 1980	361.7	209.7	75.8	86.9^e
June	382.0	234.3	77.4	91.5^e
September	376.5	246.4	75.6	97.1
December	370.2	238.0	71.4	98.3
March 1981	393.0	211.6	69.5	97.2
June	384.7	240.3	79.5	n.a.
September	356.0	240.0	73.9	n.a.
December 1981	363.5	226.3	67.2	n.a.
March 1982	365.7	233.1	70.5	

Sources: U.S. Department of Energy, Comite Professionnel du Petrole, Petroleum Association of Japan, Mineraloelwirtschaftsverband.

Notes: (1) Excludes the Strategic Petroleum Reserve, which contained 73 million barrels in January 1979, 91.2 million barrels in January 1980, 112.4 million barrels in January 1981, and 270 million barrels in August 1982. (2) Excludes the oil held by the Japan National Oil Corporation, which amounted to 35 million barrels in 1979 and 1980, increasing to 48 million barrels in 1981. (3) Excludes oil held in the Federal crude oil reserve, which amounted to 44 million barrels in 1979 and 1980, increasing to 54 million barrels in 1981.

barrel) mark, and did not deviate by more than $30 per ton from that mark all year — a placid performance in comparison with 1979.

Second, a return to a semblance of normality in the spot markets helped independent importers of finished product regain some of the ground they lost in the European market in 1979. Increased competition resulted in softer downstream product prices, and thus to a gradual deterioration of the outstanding profitability of most established refining companies in 1979. This decline in profitability also augured for a reduction in stock levels.

A third signal pointing to a large drawdown of stocks in 1980 was the rising cost of capital in all industrial countries. In the United States, interest rates peaked in March 1980, plummeted by more than 50 percent by June, then rose again to exceed the March level in December. In Japan, the trend was somewhat similar. Interest rates on call money started the year at 8 percent, rose to almost 13 percent by mid-year, and then fell back to 9.5 percent by December. A comparable pattern developed in France, West Germany, and in the Eurocurrency market.

Yet, in spite of the increased cost of money, crude stock levels did not fall in 1980; they remained high in spite of the cost. As it happens, this turned out to be quite beneficial: with high stock levels, the marketplace did not become a scene of panic when the Iran-Iraq conflict erupted in the fall of 1980.

In addition to high stock levels, however, an examination of the structure of the disruption reveals other factors behind the market's apparent indifference to the oil loss in the Gulf.

The countries most severely affected by the loss of Iranian and Iraqi oil were Japan, France, Spain, Portugal, Brazil, Italy, and assorted developing and East-bloc countries. As it happens, these are countries in which government or its agents traditionally exercise considerable influence in the activities of the oil industry. The OECD countries in this group all require companies to maintain a 90-day obligatory stock. Italy and France have very experienced state oil companies that can and have acted as procurer of oil for the home country.

It is noteworthy, therefore, that the early reactions of Tokyo and Paris included warnings to oil firms serving their markets not to procure high-cost crude on the spot markets. The French government reportedly also ordered companies *not* to draw down stocks below a level equivalent to *100* days of their sales (ten days' worth of supplies more than the normal minimum). Japan's Ministry of International Trade and Industry exercised "strong administrative guidance" over national firms that reportedly included an oil import price selling. Both Japan and France, who have been criticized in the past for their efforts to make government-to-government deals, dispatched their diplomats again, but this time with no adverse reaction from allied countries. Both governments reported considerable successes, about which many outside observers remain skeptical. Yet, few have considered the psychological boost that a government-to-government deal can provide.

In essence, some oil-exporting countries took on the role as crisis-managers for the world oil market. This effort coincided with, and to a large extent gave credence to, the crisis-management effort that went on within the IEA group of countries. In early October 1980, and again in December, the IEA delegates deliberated over the state of the world oil market, counseled participating oil companies to refrain from bidding up the price of oil in the spot markets, and urged companies to draw down stocks in a manner "sufficient to balance supply and demand." By February 1981, IEA officials were pointing to the tranquility of the spot market and to reports that some producers were actually offering discounts to buyers in order to sell excess crudes as evidence that the collective drawdown program had worked.

In fact, however, the consultations among IEA countries and companies was but a minor factor. The cooperation of the oil exporters in increased production, and the restrained search for substitute oil by the directly affected oil importing governments were more telling factors. As a result, stock drawdown policy was, once again, *not a major element* in the management of an international oil supply disruption.

The Role of Stocks in the 1980s

Coming into 1982, it was encouraging to note that the world has avoided the two extremes that would have been most damaging in the wake of the Iran-Iraq war: a too-rapid drawdown of emergency stocks that would have left the directly affected countries — Japan, France, Brazil — feeling edgy, and a too-rapid build-up of stocks that might have precipitated a 1979-like price explosion.[8]

One of the consequences of this successful transition (from a market in which Iran and Iraq were major forces in oil trade to one in which they are not) was that it encouraged various governments to believe all the more strongly their models of how the world works, and what the best policies are. Thus, advocates of letting market forces flow unhindered felt vindicated, while proponents of state intervention and *dirigisme* also felt triumphant. Within the EEC and IEA groups, the Germans, British and (since February 1981) Americans favored a *laissez faire* approach to so-called "sub-trigger" supply disruptions,[9] the French, Italians and many smaller countries favored the *dirigiste* approach.

In view of these significant differences in policy orientation, the role that importing countries will allow their emergency stocks to play in the world oil market of the 1980s is not readily apparent. To capture the range of possibilities, three types of multinational stock drawdown or usage policies must be distinguished. The *minimalist* policy is a reflection of current U.S. policy toward oil: government stocks are only for dire circmstances, as defined, for example, in the International Energy Program. The second policy is that typified by French policy, and can be viewed as an *interventionist* approach: governments of importing countries can use stocks selectively to redress spot price explosions and local or national shortages. The third approach is seldom discussed in importing country policy discussions, because it is so remote at present. That is the *dominant* approach, which calls on importing countries to amass sufficient inventories to give them the power not only to protect themselves against embargoes, and to contain explosions in the spot market, but also to heavily influence (and ideally to dominate) OPEC oil pricing decisions.

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[8] Some countries, notably Turkey and Portugal, did experience worrying supply problems and stock drawdowns. It was their unwillingness to pay the high marginal prices, rather than the sheer unavailability of oil, that caused these countries to have to draw down stocks in late 1980.

[9] A supply reduction falling short of the 7 percent level needed to trigger the IEA oil-sharing program.

Looking at stock policies volumetrically, the present trend of the importing countries appears to lead to stocks too big to leave governments satisfied with a minimalist policy, but too small to allow a policy of dominance to be pursued realistically. Proper study of these assertions would involve forecasting oil supply and demand, the absorptive capacity of Saudi Arabia, and so forth. The principal parts of the argument, however, can be summarized as follows:

> IEA/OECD emergency reserves will grow by at least 500 million barrels during the 1980s as a result of the developmnt of the U.S. Strategic Petroleum Reserve and, to a lesser extent, additions to the Japan National Oil Corporation stockpile. Given the security-orientation of the new U.S. Administration, a 500 million barrel SPR is probably the smallest being contemplated, in spite of the budget-cutting in Washington.
>
> At the same time, movement towards an IEA/OECD stockpile that could be a dominant factor in world oil pricing is being checked by the reluctance of most other IEA countries substantially to enlarge their emergency reserves. It is possible that in the near future a proposal to increase the minimum storage obligation to 100 or even 120 days' worth of net imports will be made. Most member states do not want to have to share the financial burden with the indusry to pay for such an increase, as would be necessary under most of the obligatory storage statutes. Therefore, it is unlikely that such a proposal would pass a vote in the IEA.
>
> Industry's discretionary inventories — that is, stocks in excess of the minimum obligations in Europe and Japan and in excess of minimum operating levels in the United States and Canada — will go up and down in reactions too complex and unpredictable for governments to manipulate. The very high stock levels of 1980-81 will seem anomalous a few years hence.

The importing countries now have almost enough oil in emergency stocks to be able to design and employ an interventionist stock management program. The main stumbling block is that the United States government totally lacks the desire to intervene in "sub-trigger" situations. This is ironic, because the SPR is growing so rapidly that there will soon be enough oil in the Reserve to justify contemplation of interventionist programs.

From the oil exporting nations' perspectives, in attempting to forecast the effects of OECD stocks on their interests, prudence dictates a balanced approach. It would be foolhardy to discount altogether the influence of deliberate stock policies, but it is also unnecessary to view them as the cutting edge of an effective monopsony. A more balanced view is that the use of stocks by governments will be sufficiently difficult to prevent a dominant strategy from succeeding all the time but not some of the time, and that controversy among importing countries using stocks in "sub-trigger disruptions" to quell spot market prices will arise again and again.

The difficulty that importers will have in agreeing to a stock draw-down strategy is best reflected in the very crude state of proposals that are under government review. In the past two years, the following have been publicized:

Continuation of *ad hoc* consultations between governments and oil companies. A key choice here is whether to pursue this option within the IEA framework, or to develop an alternative. The latter option may facilitate cooperation by oil producers.

A modified IEP. This uses the existing IEA framework of allocation rights and obligations, but lowers the trigger level, (that is, the amount of oil

Continuation of *ad hoc* consultations between governments and oil companies. A key choice here is whether to pursue this option within the IEA framework, or to develop an alternative. The latter option may facilitate cooperation by oil producers.

A modified IEP. This uses the existing IEA framework of allocation rights and obligations, but lowers the trigger level, (that is, the amount of oil

loss that activates the program). Other modifications could be devised to make the allocation/stock program more workable.

The stock "pool" proposal. Each country contributes 4 days' work of consumption to an international oil pool, or buffer stock. If all OECD countries were to join, the pool would contain about 130 million barrels. Upon declaration of a "localized deficit" by the group, the country or countries affected by the oil disruption have a right to purchase up to 50, 66, 75 percent of the oil depending on the number of countries affected.

A company stock "pool." Each company would sell five days' worth of oil to a central agency. When a disruption occurs, those companies directly affected would have a right to repurchase the oil at the average price during the previous quarter.

A "classic" buffer stock would differ from the third proposal principally by virtue of requiring the participation of the exporting countries. A buffer stock buys oil when the market is slack, sells it when it is tight.

The small-group approach can actually be applied to any of the other options listed above It is listed separately to give credit to the unusually strong appeal this option has for many who believe that IEA, EEC, or even OPEC coordination is needlessly cumbersome. The "big three" of the importing world (the United States, Japan, and West Germany) could exercise considerable weight in the oil market if they coordinated their stock build-up and draw-down policies.

The proposal of the Commission of the European Community, submitted to the Council of Ministers in October 1981, is that Member Countries will lower their mandatory stock requirements in a tight market from 90 to 85 days. Recognizing that some countries and some companies will have to draw down stocks more rapidly than others, the proposal calls for a kind of guarantee in which the other countries provide enough oil to the disproportionately affected country to prevent deterioration in its stock position.

At the moment, the Reagan Administration does not favor any of these sub-trigger schemes. As the SPR grows, however, its potential power will become more apparent, and interest in using it will rise. That suggests the pertinent issue for oil-exporting countries is not how to stop countries like the United States and Japan from stockpiling, but how to react to the prospect of coordinated stock management by their customers. It is not at all clear that the use of stocks in response to a "sub-trigger" disruption must always be against the interests of oil-exporting countries. Indeed, insofar as it removes the pressure on them to act as crisis-managers, coordinated stock drawdowns make life easier for countries like Saudi Arabia.

It is premature to propose a program combining importing country and exporting country actions during the supply crises. It is not premature, however, to suggest that the emergence of substantial emergency reserves calls for the development of new understandings about the roles of governments in supply and price disruptions. What should be the implicit and perhaps subsequently explicit "rules of the game" during the next few years?

The experiences of the past several years provide a number of candidates that pertain directly to oil stockpiles.

> Rule 1: Governments of oil-importing countries should not view emergency stocks as a panacea. Their effect on the market will be difficult to predict. For example, stock drawdowns may dampen spot price increases but not prevent increases in OPEC's government sales prices.
>
> Rule 2: Governments of oil-exporting countries should not regard emergency stock buildup as necessarily inimical to their interests. There is a possibility that stock drawdowns will be the edge of monopsony power, but that will be more a function of the excess of (potential to) supply over demand than of stock levels *per se*.

If there is something to these rules, then emergency stocks need no longer be viewed solely as an instrument of importers against exporters, as a deterrent against embargoes. They might be viewed, instead, as a medium for bargaining in the years ahead.

Put in another way, stock drawdowns and buildups could become central ingredients in the formulation of broader rules whose function is to prevent extreme disorder in the oil system. For example, in times of extreme oil surpluses, an agreement to stockpile by importers might be coupled with price moderation by exporters. In times of shortages, an agreement by exporters to activate shut-in production might be coupled with stock drawdowns by importers.

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The Group of Thirty
Two World Trade Center
Suite 9630
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The Group of Thirty was established in 1978 to explore basic problems in the functioning of the international economic system. It meets twice a year. Between those meetings, study groups and researchers gather material to serve as a basis for the Group's discussions.

1.12

Group of Thirty

Commercial banks and the restructuring of cross-border debt

by
M. S. Mendelsohn

This study is based partly on interviews with commercial banks and supervisors in the United States and Europe by Mario Deaglio, Karl Grun, Jenny Ireland, Roshanak Khalili and Ann Tutwiler

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Commercial banks and the restructuring of cross-border debt

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Commercial banks and the restructuring of cross-border debt

The experience of 1982-83

Until recently, the restructuring of sovereign debt owed to the markets existed as a fear rather than a reality. However, that changed dramatically in the late summer of 1982. From that date to the spring of 1983, fifteen countries began renegotiating the terms of about $90 billion of external debt owed to international banks and some other private creditors. When the full amount eventually becomes known, the total of such *debt being renegotiated may exceed to $100 billion.* Included in that total is an estimated sum of about $75 billion which has been or is still being restructured by five borrowing countries alone – Mexico, Brazil, Argentina, Venezuela and Poland.

The enormity is readily put into perspective. In the 25 years through 1982, a total of 80 debt relief agreements were signed, but only 13 with commercial banks. The large majority of relief agreements covered debt owed by governments of developing countries to the governments of the leading industrial countries. Relief agreements between sovereign borrowers and commercial banks remained isolated events through the 1960s and early 1970s. Even in the six years through 1982, only nine countries restructured debt to the international financial markets. Most were small African and central American countries and the sums were manageable or, in some cases, trifling. The two exceptions were Turkey, which restructured $3 billion of external debt to the markets in 1979 and Poland, which renegotiated $4.8 billion in 1982. Put another way, the amount of cross-border market debt being renegotiated during the ten months to June, 1983, was about 20 times larger than the amount restructured in any previous year. The $90 to $100 billion being renegotiated by the 15 countries compares with their end-1982 liabilities to the international banking system of about $210 billion gross and approximately $165 billion net (Table 1).

Table 1

Debt renegotiations with commercial banks 1982–83

debtor countries	Amounts being renegotiated ($ billions)			
			total liabilities to international banks	
	public sector debt	private sector debt	gross	net
Mexico	19.5	15	59.0	48.5
Brazil	4.7	+	56.0	51.8
Argentina	5.5	6.0(e)	22.2	16.4
Venezuela	16.3	n.a	22.7	9.7
Peru	2.0	0.3	5.2	3.3
Chile	3.4	+	10.5	8.0
Uruguay	0.8	n.a.	1.2	0
Ecuador	1.2	1.3	4.1	3.3
Jugoslavia	3.4	n.a.	9.3	7.3
Roumania	0.6	n.a.	4.0	3.7
Poland	7.0	n.a.	13.4	12.4
Cuba, Costa Rica, Nicaragua, Hondurus	2.1	n.a.	2.5	2.1
	66.5	22.6	210.0	166.5

Estimated by authoritative supervisory sources. Source for end-1982 liabilities to banking system: BIS.

n.a.: not available or applicable.

(e): estimated

+: Some private sector debt included in public sector total.

Table 2

Debt restructuring agreements signed with commercial banks 1978-82

year	debtor countries	amounts restructured ($ millions)
1978	Jamaica	83
	Peru	821
		904
1979	Jamaica	149
	Turkey*	2,930
	Guyana	29
		3,108
1980	Togo	69
	Zaire	402
	Nicaragua	562
		1,033
1981	Jamaica	103
	Sudan	538
		641
1982	Poland	4,800
	Guyana	35
		4,835

Source: IBRD.

*1979 agreement extended in 1982.

This study by the staff of the Group of Thirty focuses on the crucible of recent experience, but set in a longer perspective. It is based partly on interviews with a widely representative selection of international bankers and supervisors to discover whether, in their view, debt problems might be better anticipated and handled in the future. However, it contains also detailed case histories of the recent Mexican and Brazilian negotiations published in that form for the first time, so far as is known, to illustrate two very different approaches to the restructuring of international market debt followed, to varying degrees, by other countries. The study includes also a review of experience gained over a quarter of a century in the Paris Club, in which debt relief is negotiated between governments, and the possible relevance of that experience for the banking system. In addition, there is a description of the aims of the newly founded Insitute of International Finance (the Ditchley Group) and the view which bankers take of that initiative, with special reference to the tensions that have arisen during recent debt renegotiations between larger and smaller banks.

Main findings

The following are the main findings of this study:

- A critical question is whether the present rash of international debt renegotiations with the banking system represents a *passing or enduring phenomenon.* A majority of those interviewed believe that while the present crisis has special and possibly unique causes, the damage may take several years to undo. The special circumstances are well known. A concerted disinflation initiated by the major financial powers from late 1979 to provide a basis for sustainable, uninflationary economic growth in the future, had a more brutal combined effect than intended by any single government. The impact was especially harsh because the main burden of counter-inflation was placed on monetary policy. The rise of nominal and real interest rates to exceptionally high levels and the accompanying stagnation of world output and trade over the three years through 1982 simultaneously increased the cost of debt and reduced the ability of debtors to service their obligations.

The impact has not been confined to sovereign borrowers by any means. The president of the World Bank, Mr. A. W. Clausen, recently pointed to the considerable pressures on businesses while also underscoring the familiar distinction between companies which can be wound up for creditors, and countries which cannot. He observed that in America alone about 53,000 businesses went bankrupt in 1982, "and a great proportion of their debt disappeared with them".*

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*Jodidi Lecture, Harvard University, February 24th, 1983.

In the view of most bankers and supervisors who co-operated in this study, it is unlikely that the stretchings out of principal repayments recently negotiated or still in the course of negotiation will, of themselves, prove sufficient to restore the full debt-servicing capacity of many of the debtor countries. The recent negotiations have concentrated mainly on the stretching out, or restructuring, of repayments of principal falling due in 1982 and 1983. At the time of writing, the outlook for the global economy still remains uncertain. Even if the recovery in world output and trade now started is maintained, as hoped, a number of countries may still need to return to the bargaining table with their international bankers to renegotiate the terms of principal repayments falling due in 1984, those falling due in the year after and even, perhaps, in the year after that.

- Recent experience has provided a crash course in the *approach to rescheduling adopted by debtor countries.* That is why detailed case histories are provided here, on pages 23 to 30, of the very different ways in which Mexico and Brazil tackled their difficulties. The Mexican authorities acted with a suddenness and determination which struck many bankers as unnecessarily dramatic and even brutal at the time, but effective in retrospect.

By contrast, the Brazilian government and central bank tried to avoid facing creditors with a *fait accompli.* They were motivated by the well-intentioned aim of quietly winning creditors' confidence. In the view of most bankers and supervisors interviewed for this study, the Brazilian authorities deserve full marks for effort, but less for accomplishment. However, a majority of countries in recent external debt renegotiations with commercial banks have tended towards the Brazilian rather than the Mexican approach. Broadly speaking, Argentina and Peru are described as having followed the Mexican path, while Chile, Venezuela, Uruguay and Poland are said to have gone the Brazilian way towards restructuring.

Some approaches have been individualistic. In Jugoslavia's case, the government approached the International Monetary Fund which in its turn informally approached the country's main creditor banks acting in this case as a catalyst to get negotiations started rather than only in its more usual and public role of a catalyst in the adjustment process, designed to restore a member country's credit-worthiness.

Hungary was cited by some bankers as a country which had avoided restructuring its external debts partly by the "Brazilian approach" of taking its creditors into its confidence, but by doing so well before any difficulties threatened, instead of approaching its bankers only at the emergence of problems. The Hungarian authorities, who have, over the years, developed especially close relations with the western banking system, avoided even the taint of irresponsible behaviour by informally asking the IMF what kind of programme the Fund might recommend if asked. The Hungarian government then adopted of its own accord an economic programme along the lines informally suggested to it, and was thus able to go on attracting new capital on its own merits.

- *The impact on banks* has been cushioned by a stiffening of restructuring terms during the past three years. Whereas in 1978 and 1980 principal was still being restructured over five to six years with two years of grace and at lending margins of 1¼ to 1½ per cent, recent restructurings, notably for Mexico and Brazil, have provided for longer stretch-out periods of eight years, but still with no more than 2½ years' grace and lending margins of well above 2 per cent, plus arrangement fees. This compares with margins of well below 1 per cent obtained by Brazil until 1980 and lending margins of ½ per cent available to Mexico as late as June 1982. In effect, creditor banks are being belatedly compensated for the very fine terms which they felt obliged to concede in the borrowers' market which persisted through most of the 1970s and into the early 1980s. If arrangement fees are taken into account, the restructured debt is yielding banks about 2 per cent a year more than the terms on which most of that debt was originally contracted. Moreover, during the grace periods, the banks obtain those yields on the total sums of restructured debt outstanding, because none is being run down during those years. On an admittedly very rough calculation, which takes into account that many of the leading banks obtain their funds at an average cost below Libor, banks may be earning about an extra $1¾ billion a year on the $90 billion of cross-border debt recently renegotiated or being renegotiated. Such earnings give banks more scope than in the past for making adequate provisions against full service and possible losses.

Far less welcome to banks has been the increasing tendency since 1979 to stretch out over several years principal repayments of short term claims originally extended for periods not exceeding one year. In such cases banks find themselves locked into positions far beyond those they had originally decided to take. All bankers interviewed expressed their resentment at this tendency, and especially regional and smaller banks which had made no medium or longer term commitments to borrowing countries. This resentment has found practical expression on the part of many banks, which have resisted pressure to restore interbank lines to troubled sovereign borrowers and declined to maintain even their full trade-related credits to such borrowers.

- *The kinds of debt* being restructured over the past three years has broadened, although stretching out is still confined mainly to principal payments. However, short term debt and even interest arrears have come to be included in restructurings, as already mentioned. Beyond that, a decision to go on excluding debt to international bond holders was carried only by a single vote of the Mexican advisory committee early in 1982. The sums involved are not negligible. In the four years through 1982, developing and east European countries issued a total of more than $15½ billion on international bond markets including more than $8 billion issued by Mexico, Brazil and Venezuela and nearly $6 billion by Mexico alone. The servicing of bond issues has so far been allowed by major creditors to continue unimpeded because of the damage which might be caused by any interruption to confidence in international bond markets and the large number of individual investors in those markets, who have come to rely on a special protection of their interests, much like small depositors at banks. The large minority vote to include Mexico's bond obligations in the total of debt to be restructured, was viewed by some bankers as an attempt to secure equal treatment for all creditors, but also as a form of pressure on Swiss banks, which have a special interest in the smooth functioning of international bond markets, but which have allegedly been reluctant to maintain interbank lines and credit flows to countries in difficulties. The narrowness of the vote suggests that the sanctity of bond servicing can no longer be assumed with as much assurance as previously.

- The danger of outright *default* is dismissed by most bankers and supervisors who participated in this study. They do not believe that countries will risk their trade by defaulting outright. The point was strongly made by a senior spokesman of a large and advanced developing country. He said that if his country ever defaulted, its ships and aircraft everywhere would instantly be seized by creditors, as would any goods that his country tried to export. In fact, the only significant defaults which have so far occurred in the 20th century have been on the part of two countries which chose to withdraw or felt themselves excluded from the world community for protracted periods after 1917 in one case, and after 1949 in the other.

However, the majority view that countries will not default outright takes into account the difficulties which some borrowers may have in returning to creditworthiness as promptly as creditors would like. At the same time, it is proper to record the view of a minority of bankers who participated in this study and who do not wholly rule out the danger of default in cases where countries find it politically impossible to adjust on the scale and in the time sought by creditors.

While formally declared default remains an unlikely prospect in the view of the majority of respondents, *default by attrition* has begun to creep into the restructuring process. An example is provided by a small developing country whose debt, including some principal arrears and some interest arrears, has been restructured regularly during the past three years. While the debt is negligible for the international banking system and highly manageable even for the country's creditors banks, it is nevertheless large in relation to the country's economy. Each year the debtor country fails to meet the restructuring terms in full and they are therefore negotiated once again. The time involved stretches the senior management resources of the creditor banks, who now delegate the annual restructuring negotiations to more junior personnel. The process, if continued, would eventually come to represent default in all but name, and some of the larger creditor banks would willingly write off their claims on the country excepting for their fear of the dangerous precedent that this might create. Indeed, they are concerned by the precedent already created.

- In the case of private sector debt, a uniform rule applies for *claims written off* by banks, whether the claims are on domestic or foreign borrowers. Such write-offs remove non-performing assets from the books of the banks, but they are not synonymous with money lost for all time. It is common for banks to recover a large part of loans they have written off, even though the process may sometimes take years.

The main *information gaps* cited by nearly all respondents were timely information on short-term credits of up to a year, including trade-related and interbank credits. But all of them acknowledged the extreme difficulty of obtaining such information in any useful way from highly fluid markets.

For instance, a European bank supervisor pointed out that short of daily reports on interbank positions (impossibly costly), the usefulness of quarterly, monthly, or even weekly "snapshots" would be vitiated to the extent that banks learn to cover their positions for the relevant reporting dates.

- Several respondents admitted that *information gaps* existed as much *within their own banks as in the system*. For example, one European bank reported a shift in its interbank claims on Brazilian banks from $2 million to $30 million in a single day. Another bank mentioned the example of an African bank which had raised $500 million from small bank participants in the interbank market over a period of weeks without any awareness on the part of its bigger creditor banks that it was doing so. The information gaps existing within banks were graphically illustrated by a European banker who said that he would not have sanctioned a further growth of interbank credits to Mexico as late as June 1982 had he been informed of the extent to which they were building up. Closer questioning revealed, however, that the information had in fact been known to his subordinates, but not passed upwards. "If the figures had been brought to my attention, I would surely have acted differently," he said.

- Several respondents said that present difficulties had provided a salutory reminder of the *need for judgment* rather than ever more statistics, whose sheer mass and inevitable deficiencies can indeed provide the timid with an excuse for postponing judgments indefinitely. A number of bankers made the point that the soaring cost of debt and the stagnation of world output and trade should in themselves have provided early warnings that many sovereign borrowers would run into difficulties, especially those with large amounts of market and floating rate debt. One banker said:

> "Banks would not have acted differently had quicker detailed information been available to them. What is important is not only information, but how we react to it."

- One indication that the market continued to concentrate on the perceived *outlook for individual countries* rather than the gathering difficulties threatening all large market borrowers is provided by the difference of terms to Brazil and Mexico before the crisis. The cost of new money in the international bank loan market began rising for Brazil as long ago as mid-1980 and by late 1981 had already reached the levels subsequently incorporated into restructuring agreements. Mexico, by contrast, was still obtaining new medium term bank loans at a mere ½ per cent above Libor as late as June 1982, on the mistaken assumption that petroleum prices were uniquely immune from the forces of supply and demand.

While recognising the limitations of ever more information flows in themselves, respondents nevertheless stressed the need for the provision of fuller information by debtor countries and more efficient monitoring by the supervisory authorities of banks in creditor countries. For example, many of the 98 countries reporting their medium and long term debt to the World Bank do not include private non-guaranteed debt. Mexico is prominent among those which have not so far done so, and the staff of the Bank has found a close relationship between countries which provide inadequate information and those that run into difficulties.*

- The difficulty of adequate debt reporting in borrowing countries is recognised as being partly political and not just technical. The reason is that prompt and comprehensive information on the volume and tenor of new debt contracted by the public and private sectors can be obtained only where *national information-gathering agencies are* given sufficient political independence and authority to command the supply of information and to face their governments with the facts, welcome or otherwise. The political sensitivity of such a role is believed to have impeded fuller information flows from a number of debtor countries.

In one sense, complete information becomes more important in the event of a crisis than in anticipating difficulties, because trouble can be foreseen even when the last number is not known. However, when the renegotiating of debt actually begins, it becomes imperative to know exactly what is being renegotiated, and precisely how much is owed for how long and to whom. This is where practical difficulties often arise. The volume of

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* World Debt Tables, 1982-83, and World Development Report, 1983, IBRD.

Mexican private sector debt to external creditors to be included in that country's restructuring negotiations was officially estimated only eight months after full debt service had been suspended and in Brazil's case, the total being negotiated still remained unknown in June, 1983, although that country's difficulties had begun to emerge in August 1982.

- Most respondents said they would like a still further improvement of relations with international agencies, especially the *International Monetary Fund* and the *Bank for International Settlements.* However, limitations were also mentioned.

The Bank for International Settlements, which has periodically provided bridging finance, for instance, to the United Kingdom in 1976 and more recently Hungary, has said that its limited resources might not allow it to go on providing large bridging financing for non-member countries, as it did for Brazil and Mexico in 1982, and for Chile in May, 1983. Commercial banks look to the BIS mainly for a continuing improvement of information on the terms and structure of cross-border debt as reported to the the BIS by the central banks of the main financial market countries. However, they reported an inhibition about making direct contacts with the BIS, which they regard as the central bankers' bank (by contrast with the ease of informal contacts reported to exist with the staff of the IMF). In addition, commercial bankers see the BIS as filling a useful role in providing the forum in which bank supervisors of the main creditor countries have been meeting for several years to try to harmonise supervisory practices. The deficiency seen in present arrangements is that the understanding among member countries of the BIS on the division of responsibility for bank supervision between host and parent countries of international banks still lacks any clear understanding about division of responsibility for the solvency of foreign branches and subsidiaries.

Bankers interviewed have attached new importance to the International Monetary Fund as a catalyst in the restructuring and adjustment process. This dates back some years to the failure of programmes presented to and reviewed by creditor banks for Peru in 1976 and Nicaragua in 1980. Since then, banks have attached increasing value to adjustment programmes agreed by borrowing countries with the IMF itself.

The response has been more mixed to the newly active role played by the IMF in 1982, when it made complementary bank financing a condition of programmes agreed with Mexico and Brazil on the little publicised precedents of complementary financing provided by the banking system and the IMF to Togo in 1980 and the Sudan in 1981.

- Broadly speaking, the large international banks have welcomed the efforts of the International Monetary Fund, strongly supported by the American Federal Reserve System and the Bank of England, among others, to maintain flows of finance from the banking system to borrowing countries experiencing difficulties. However, many regional and smaller banks have expressed some resentment and have actually resisted what they regard as unjustified pressure to go on lending. Moreover, some large banks, while welcoming the role of the IMF and other authorities in helping to maintain credit flows to countries where those banks themselves are heavily exposed, have said they would resist similar "arm-twisting" in the case of countries where they do not have substantial exposure. Reflecting the ambivalent attitude of several banks to the IMF's new approach, a major US bank said that while applauding the IMF's role in Mexico and Brazil, it would not comply with similar requests to go on lending to eastern Europe, where it is relatively less exposed.

A European banker said:

> "At first I thought Mr de Larosiere's methods were shocking. However, on reflection, it was the only way to proceed. But, quite frankly, our willingness to participate in such exercises in the future might be limited by our lending capacity."

Bankers responding to this survey spoke favourably of relations with the staff of the IMF, and staff reports to the IMF executive board have for very long been widely "leaked" to the banking community, although there is no suggestion that this has been done by the staff of the IMF. Such reports are usually circulated among banks either by the governments of the debtor countries themselves or through the authorities of the creditor banks' host countries. However, justifiably or otherwise, a number of bankers believe that staff reports and IMF adjustment programmes are often based on incomplete and even misleading information obtained from the authorities of borrowing countries. The bankers interviewed do not necessarily attribute such misinformation to bad faith, and certainly not in all cases. But they do suspect that the value of staff reports and the viability of adjustment programmes agreed with the IMF may be equally vitiated in some cases. Not only bankers, but some *supervisors* too, said that they would like a closer relation with the IMF. One of them said:

> "What we need as supervisors is to have better view of the IMF's perception of different countries."

Respondents were divided, not only numerically but often in their own minds, about the balance of advantage of fuller disclosure by debtor countries to the financial system through the IMF. On the one hand, many respondents believe that IMF insistence on complementary financing imposes a duty on the Fund to provide the banking community with fuller information on member countries thus assisted, with the consent of the countries. However, there are many who believe that this would tend to inhibit disclosure by member countries to the Fund.

- The evolution of the *Paris Club* (see details on page 31) provides some guidance for the restructuring of cross-border debt. The "club" is the forum in which the governments of debtor countries and the governments of aid-donating countries have renegotiated the terms of intra-government debt since 1956, and a body of precedent and unwritten rules has evolved over the years. Yet the evolution has been a reluctant one at every stage. The appointment of a secretariat was resisted for almost 20 years. The workings of the "club" have seldom been fully spelled out in public, and even references to the "club" are only grudgingly tolerated by the creditor governments. The explanation is the understandable reluctance to formalise, or at least admit to any formalisation of restructuring procedures, for fear of inviting more restructuring applications.

Most commercial bankers interviewed for this survey take a similar attitude towards any attempt at developing a more "structured" approach towards the renegotiation of cross-border debt to the financial markets. They, too, are concerned that the evolution of a set of restructuring rules might have the effect of inviting more applications for debt renegotiation.

However, in spite of the long reluctance of the Paris Club to become a club, it has nevertheless evolved into one. Its rules require debtor countries to agree an IMF adjustent programme before requests for relief are considered, the creditor countries have tried, though without total success, to limit restructuring to the principal repayments due within a two-year period at most, and have tried to oblige borrowing countries to renegotiate debt to other creditors on the same terms as those applying to debt restructured within the club. In spite of that, the rules have had to be eased over the years. Arrears of principal and even interest are now sometimes included in restructurings. Relief is often given on principal repayments due in succeeding years, and a conditional undertaking to consider further relief in the future is often given by creditor governments if the debtor country can show at the next negotiation that it is continuing to adjust its economy on the lines agreed with the IMF.

● International debt to the banking system differs so widely from case to case in structure, tenor and the composition of the creditor banks that there could be *no common systematic approach to restructuring* as in the case of sovereign debt to a limited number of sovereign creditors, even if banks and borrowing countries desired such a thing. It is not only banks which would resist an evolution towards a more formally structured approach. Debtor countries themselves showed that they were opposed to the concept of any generalised debt renegotiations with creditor countries on common terms at a meeting in early 1983 of UNCTAD, the United Nations Conference on Trade and Development. The reason for this reluctance was the obvious wish of borrowing countries to maintain differences of creditworthiness between themselves and to strive individually for the highest credit ratings and most favourable borrowing terms available to each of them in any given set of circumstances.

- While the process of renegotiating cross-border debt has not so far become more structured in any recognisable sense, *the approach of banks* has almost imperceptibly been influenced by experience predating the latest concentration of sovereign debt reschedulings. An American banker put this into perspective by observing that the renegotiation of corporate debt is a matter of routine in the United States and, because American companies usually have several bankers and in addition rely on loans that have been syndicated in the domestic market, the renegotiation of corporate debt is often undertaken under the leadership of some of the creditor banks acting for all.

While banks in other leading industrial countries also restructure corporate debt as a matter of routine, the debt thus restructured is more often syndicated debt in the United States than in many other countries. The American banks, which have taken the lead in the restructuring of South American debt recently, are therefore perceived by many European bankers who were interviewed as having more practice in leading such restructuring groups. American leadership of restructuring groups was therefore welcomed by several European bankers taking part in this study, even by some who complained at the same time of the "bullying tactics" used, while also acknowledging the practical usefulness of such tactics.

- In practice, advisory or steering groups managing the restructuring of sovereign debt to banks have been led by those banks having the largest exposure to the debtor countries, in other words, the same banks that took the lead in the lending process. While some of those interviewed showed a certain resentment at having a handful of international banks at the head of most or many renegotiating groups, several others welcomed this situation on the ground that those banks were acquiring growing skill and experience of debt restructuring.

On the other hand, a number of *regional and smaller banks,* who were happy to follow the lead and judgment of the major international banks when they first entered the international medium-term lending market, have come to feel aggrieved at their subordinate position in the restructuring process. This attitude was strongly expressed by regional and smaller banks interviewed in the United States. A typical comment from an executive of a smaller banks was: "We simply get a telex from the steering group banks that they are meeting in Zurich or wherever, that they have agreed on such and such terms, and would we kindly telex our agreement by no later than 2 p.m."

The sense of grievance thus expressed is not in all cases impotent. The banker cited above said that his bank had refused to restore its total facilities to Brazil to the levels of June 1982, plus an additional percentage, as requested by the IMF and the Federal Reserve System. He went on to say that if the borrower retaliated by paying interest on his bank's remaining claims below the common penalty spread, it would seek redress from other syndicate banks under the "sharing clause" of rescheduling agreements.

Executives at major international banks are less than deeply moved by the present grievences of smaller banks which, in their view, having been happy enough to enter the markets in a subsidiary role when the going was good, should not complain at times of adversity.

In practice, smaller banks may prove less cooperative in the restructuring process because their entry into international lending was often influenced by the desire for closer links with lead managing banks rather than the wish for closer relations with the borrowing countries. By contrast, the managements of the smaller banks are more concerned with the attitudes of their directors and shareholders than their relationship with bigger banks in the colder climate of debt restructuring.

- Bankers who cooperated in this study were unanimous in saying that uniformity in making *provisions* against bad and doubtful claims was neither desirable nor possible, partly because of differences of auditing standards and tax treatment of provisions in the host countries of creditor banks. More important, perhaps, is the view strongly expressed by several bankers and some supervisors that the level of provisions is a matter for each bank to decide for itself on its own view of prudent conduct.

A European banker said:

> "If you take the responsibility for deciding provisions away from individual banks, you weaken their approach to all of their lending."

An allied point made by an American banker was that any official pressure on banks to make provisions exceeding their own view of prudent levels would undermine their ability to provide incremental financing to sovereign borrowers in difficulties. Yet another objection to uniform levels of provisions was raised by a European banker who pointed to differences in the capital structure of individual banks. He said:

> "Banks with a relatively large capital base can safely make relatively smaller provisions than those which have relatively small equity and should therefore put aside larger provisions than other banks."

An assertion made by several commercial banks was that US supervisors were politically influenced by the State Department in their assessment of claims held on sovereign borrowers by American banks. This was strongly denied by all the US supervising agencies.

- Recently a number of proposals have been made for *official guarantees* of cross-border lending or for schemes which would enable banks to sell at a *discount* some of their restructured cross-border claims. At the commercial level, at least one investment bank has actively started exploring the possibility of helping to create a market for such discounting. At the theoretical level, proposals have been made for discounting facilities to be offered either by central banks of the major market creditors acting individually or, alternatively, through some international initiative.

However, a number of difficulties were stressed. At the extreme, one European banker described all such proposals as "dangerous nonsense". Another said, "Where is the central bank that would be willing to take non-performing assets onto its books?" And, a banking supervisor drew an important distinction between occasionally and temporarily discounting the paper of an individual bank to tide it over a liquidity difficulty, and any generalised schemes for discounting cross-border claims of commercial banks.

An underlying risk is that if national authorities acted individually to provide some generalised form of guarantees or discounting the cross-border claims of banks in their jurisdiction, each country might do so on different terms. In that case, the outcome might be a financial equivalent of the undeclared trade war that has evolved through the competitive subsidisation of export credits.

An international initiative to provide guarantees or discounting facilities through some cooperative approach would avoid such a risk, but might lack motivation for precisely that reason. Moreover, the negotiation for the creation of an international discounting facility might be drawn out indefinitely in the absence of a crisis and prove impossible in the heat of a crisis – a crisis being defined here as a large accumulation of repeated cross-border market restructurings.

The discounts at which commercial bank claims are taken over will either reflect the realities of cost and risk by being pitched at market levels, in which case banks may have no particular inducement to take advantage of the facility. Alternatively, if the rates of discount are not pitched at market levels, resistance may be encountered from the electorates of creditor countries, and banks might be reluctant either to face such resistance or to pay for it by some loss of their independence.

From the point of borrowing countries, a system of official discounting might be equally unattractive whether at subsidised or market rates. More credit-worthy borrowing countries, especially those that have avoided restructuring, might feel their competitive edge as borrowers being blunted in the case of officially subsidised discounting facilities at uniform rates. In the case of official discounting at market rates, weaker borrowers would dislike a new and publicised measure of their credit rating, although that would provide an extra spur which would be in the borrowers' own interests.

The last named issue would arise equally in the case of officially sponsored discounting schemes and any form of discounting spontaneously created in the markets. That need not deter private initiatives for the creation of a discount market, but it is difficult to envisage such a market evolving at any easily foreseeable time to a size enabling it to absorb anything more than the claims held by some smaller banks. That much, however, might be welcomed on all sides.

- In confidential interviews bankers expressed as many reservations about the *Institute of International Finance* (the Ditchley group) as hopes for it.* On the positive side they welcomed its possible usefulness as a centre for gathering and disseminating information in a neutral way. Yet a number of bankers, especially in Europe, viewed this unarguably laudable function with some scepticism. They questioned whether the Institute would in fact be able to add significantly to the volume of information already available, whether more information itself would be especially useful, and whether the group might not help precipitate rather than prevent difficulties. If it really succeeds in persuading debtor countries into a more open attitude towards all creditor banks. The Swiss banks as a group hesitated to join the IIF until persuaded to do so by the Swiss National Bank.

Some other European bankers said they would join the IIF only because it might "look odd" if they did not, and several other dismissed it as a "sop" to regional and smaller banks, especially in the United States. Some bankers were as much concerned about the possibility that the IIF might acquire real influence as by the belief that it might prove ineffectual. Aside from the risk already mentioned, that the mere dissemination of more information on debtor countries could have the perverse effect of hastening rather than preventing difficulties, one European banker expressed the fear that the Institute might soon find itself acting in fact even though against its expressed wishes as a perceived credit agency. In that case, he added, such credit ratings or perceived credit ratings might be used by bank supervisors in classifying cross-border loans on the books of banks in their jurisdiction.

Some recent lessons

Some of the important lessons learned from recent experience include the following:

- Those commercial banks which had tended to assess sovereign borrowers in isolation have been forcefully reminded of the need to view such borrowers in a wider context. Even inherently viable borrowing countries have encountered difficulties in maintaining full service of their international debt because of the high real interest rates and economic stagnation of the global disinflation of 1979-82.
- While information gaps, especially on short-term credit flows, remain a matter of legitimate concern to creditor banks, there has been a renewed recognition of the need for the exercise of more

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*See also page 34.

judgement in the international lending process.

- When countries do run into debt-servicing difficulties, the prompt and even dramatic reaction exemplified by Mexico has seemed more efficient than the well-intentioned approach of some other countries, notably Brazil, which lost time and money by engaging in long informal discussions with creditors before suspending full debt service.
- Cross-border debt renegotiation by commercial banks has not and is unlikely to become, a structured process, as in the case of intra-government debt renegotiations within the Paris Club. However, experience gained in the Paris Club and in the routine renegotiations of syndicated domestic corporate debt in the United States has provided some valuable guidance for creditors and debtors in the renegotiation of cross-border debt to the commercial banking system.
- Experience in the Paris Club has shown the difficulties of compromising between conditions too lax to induce sufficient adjustment by borrowers and too harsh to be met. That difficulty has been partly addressed by arrangements under which creditor governments undertake to consider favourably further applications for debt restructuring provided the debtor countries continue to adhere to the adjustment programmes agreed with the IMF. Although commercial banks have not and may not follow that precedent in an openly declared way, they have come to recognise that it may take several years for some countries to be able to resume full debt service, even on the most promising view which can reasonably be taken of the world economic outlook at this juncture. However, there is a widespread belief that the worst initial "shock" of cross-border debt renegotiation with the commercial banking system has been absorbed more smoothly than many critics believed possible even as recently as mid-1982.
- The new and more active involvement of the International Monetary Fund, the Bank for International Settlements and national authorities like the Federal Reserve System and the Bank of England provides concrete evidence of the need for a closer and more coordinated approach as perceived by creditors, bankers and the authorities alike, in the interests of maintaining the viability of the banking system as a major and indispensable channel for the flow of funds from surplus to deficit countries.
- The formation of the Institute of International Finance (the Ditchley Group) recognises the importance attached to a fuller and closer dialogue between commercial banks and borrowing countries. It recognises also the need to give greater recognition to the increasing and valuable role in the international lending process played by regional and smaller banks.

Two approaches to restructuring: Mexico and Brazil

In the latter part of 1982 and the first half of 1983, Mexico and Brazil restructured record amounts of external debt owed to the international banking system. The sums were about $35 billion in Mexico's case and about $5 billion in Brazil's, compared with previous records of $4.8 billion set by Poland in 1982 and $3 billion by Turkey in 1979.

Mexico and Brazil followed similar paths in some respects, but not all. Excepting for relatively minor interruptions of service by some private sector borrowers in the two countries, Mexico and Brazil both maintained full external debt service until they suspended it to nearly all creditors.* In the case of both countries, the bulk of debt renegotiated was public sector debt and the restructuring was confined almost entirely to a stretching out over six to eight years of repayments of principal due to have been made in 1983 and 1984. Both countries agreed to adjustment programmes with the International Monetary Fund which, for the first time, made substantial complementary new financing by the banking system a condition of providing assistance of its own.

However, the differences of the approaches adopted by Mexico and Brazil are instructive, and explained only partly by the initial belief that Brazil was suffering merely a "contagion" from Mexico.

The Mexican authorities acted with a suddenness which at first took the financial community aback, but which over time began to provide the assurance of a business-like approach. A moratorium on the repayment of nearly $20 billion of principal of public sector debt due to international banks and the appointment of a centralised advisory committee of creditor banks were announced on the same day, namely August 20th, 1982. Terms for the restructuring of the suspended repayments were likewise proposed on the same day and bridging finance from the American government and the Bank for International Settlements was announcing two days later.

Within ten days, foreign exchange controls were imposed, which impeded the servicing of Mexican private sector debt, but which also stemmed flights of 'hot money', a move viewed by many bankers interviewed for this study as coming late but, at least, better late than never.

At the same time the Mexican authorities enlisted the support of the Federal Reserve System and the Bank of England to persuade the financial community not to reduce interbank lines to Mexico, a preventative move which contrasted with the Brazilian approach of trying to restore interbank lines only after they had first been heavily eroded. The persuasion of the financial community to maintain credit to Mexico in the interbank market took the form of what was authoritatively described in interviews for this study as "heavy pressure" on international banks. But, aware of the uncomfortable precedents set during the impasse over the American hostages in Iran in 1979 and 1980 and during the South Atlantic war in 1982, great care was taken to avoid the impression or threat of any freezing of interbank lines.

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* An important exception in the case of all countries is that debt to the World Bank is always serviced promptly and in full, because of the Bank's inflexible policy of treating any interruption of service as a default, which threatens to force borrowers into default to all creditors under cross-default clauses.

In dealings with the International Monetary Fund, the Mexican authorities agreed from the beginning that the managing director of the IMF should seek complementary bank financing.

The essence of the Mexican approach was an instant moratorium, the simultaneous appointment of a single advisory committee to represent all creditor banks, the prompt arrangement of bridging finance, a delayed imposition of exchange controls, but one which was not delayed excessively, prompt action to maintain interbank lines, and clear proposals at each stage for the amounts and terms of debt being restructured. Moreover, having imposed foreign exchange controls which impeded the external debt servicing of Mexican private sector debtors, the Mexican central bank very soon made arrangements for taking over the foreign exchange liabilities of those debtors. This made it possible for foreign bank supervisors to classify such loans on the books of banks in the United States and elsewhere as "performing loans".

Brazil acted very differently. Its difficulties began in the interbank market as early as August, 1982, but the first official announcement by the authorities was made only on October 25th and, even then, it promised an approach for conditional financing to the International Monetary Fund only after the elections to Brazil's federal assembly on November 15th.

Throughout November, the president of the Brazilian central bank sounded out banks in the United States and Europe, seeking up to $6 billion of new financing, while also entering into preliminary discussion with the IMF.

It was not until December 20th, 1982, that the Brazilian authorities invited some of the banking community to represent its creditors in the negotiation of a restructuring of its debt, and even then four groups of representative creditor banks were created instead of one. Each of these four was given a distinctive task. The first was asked to raise almost $4½ billion of new financing for 1983. The second was asked to reschedule $4 billion of principal repayments due in 1983, mainly of public sector debt. A third group was appointed to try to persuade the financial community to restore trade-related bank credit lines, while a fourth was given the task of trying to persuade the financial community to restore interbank lines to Brazil to their level at mid-1982.

The main difficulties encountered by the four groups appointed at this very late stage were that their functions overlapped and even conflicted to some extent, and that they were being asked to address problems which had become more acute during the delay in making a formal approach to commercial bank creditors through clearly identified representative banks. For instance, Brazil was trying to claw back large lines which had been reduced in the interbank market, a far more difficult exercise than Mexico's prompt action in putting strong pressure on the markets to maintain those lines from the start, an exercise in which it received considerable help from the American Federal Reserve System and the Bank of England.

New financing was agreed with the banking community only on December 31st, and the sum was $2.2 billion, or little more than a third of the amount of up to $6 billion ambitiously being sought only a month before. Four days later, having obtained new financing, the Brazilian authorities finally acted to suspend the repayment of nearly $5 billion (revised upward from $4 billion) of principal repayments due in 1983 on public sector debt to the international banking system. This suspension, coming immediately after an agreement on new financing, created an unfavourable impression on the markets, according to many bankers and supervisors interviewed for this study.

The impracticability of trying to handle the problems of Brazil's debts to the international banking system through four distinct representative groups of banks was implicitly recognized on January 24th when a single centralized committee of creditor banks was formed for the first time, a full five months after the first signs of difficulty. The first meeting of that centralized committee at premises provided by the Bank of England reflected some of the confusion which had now arisen. Some of the sixteen banks invited did not send representatives. On the other hand, a number of other banks sent representatives, uninvited, because of their membership of the four advisory groups created a month earlier, but now dissolved.

On the same date, the managing director of the International Monetary Fund explicitly made the restoration of interbank lines to Brazil a condition of IMF assistance to that country, representing a shift from the 'voluntary' approach which the Brazilian authorities had previously been hoping to achieve. Throughout this period, the Brazilian finance ministry and central bank had also tried not to interfere with market forces by imposing only partial exchange controls to allow the servicing of private sector external debt, although some such servicing was in fact interrupted.

In the view of many bankers and some supervisors interviewed, the well-intentioned attempt by the Brazilian authorities to go on allowing free play to market forces in the interbank market and partly on the exchanges did not succeed in its aim of maintaining market confidence. On the contrary, by hesitating to act more promptly and decisively, the Brazilian authorities allowed the external debt situation to worsen and, justifiably or otherwise, conveyed an impression of indecisiveness to the foreign creditor banks which they were seeking to reassure.

Mexico's debt restructuring, 1982-83

1982

August 20:

The Mexican authorities invite 12 international banks (later increased to 13) to form an advisory committee and meet representatives of those banks in New York to propose a 90-day moratorium on the repayment of about $19½ billion of principal of public sector debt due to about 1,400 banks in 1983.

August 22:

The Mexican finance minister telexes coordinating banks in the major creditor countries and the key US regional centers, informing them that the US government is providing $1 billion in prepayment for imports from Mexico plus a bridging facility of $925 million and that the Bank for International Settlements is providing a similar $925 million of bridging, pending the negotiation of an agreement by Mexico with the International Monetary Fund. The banks thus informed, a larger number than those comprising the advisory committee, are asked to pass on the information to all the approximately 1,400 banks involved.

August 23:

The 90-day moratorium proposed three days earlier goes into effect.

September 1:

Mexico announces foreign exchange controls and bank nationalization. This former constrains the ability of Mexican private sector debtors to service their external debt, even in the case of Mexican companies which are themselves earning enough foreign exchange to go on meeting their external obligations.

November 16:

The managing director of IMF meets representatives of the 13-bank Mexican advisory group at the New York Federal Reserve Bank and indicates in general terms the net financing that will be required from the commercial banking system to complement IMF assistance to Mexico. This is the first time that the IMF has sought large complementary financing from the banking system as an essential part of an agreement with a member country.

November 23:

The Mexican authorities extend to 120 days the 90-day moratorium that went into effect from August 23rd.

December 1:

Spelling out his initial request of November 16th, the managing director of the IMF asks the Mexican advisory group to obtain written commitments by December 15th from all of Mexico's creditor banks or as many as possible for a total of $5 billion of complementary financing.

December 8:

The Mexican authorities telex the 13 banks of the advisory group proposing terms for the $5 billion of complementary financing in the course of arrangement. The request is for financing of 6 years with 3 years' grace at a fee of ½ per cent and with a margin of 2½ per cent above US prime.

At the same time, Mexico telexes to the advisory committee its proposals for rescheduling all of the approximately $19½ billion of principal repayments due on Mexican public sector debt to foreign commercial banks between the moratorium of August 23rd, 1982 and the end of 1984. The terms are for a restructuring over 8 years, with 4 years' grace, a fee of 1 per cent and a lending margin of 1⅞ per cent above Libor or 1¾ per cent over US prime.

December 20:

The Mexican government announces that Mexican private sector companies may pay the peso equivalent of external debt service into the central bank of Mexico, which will assume the foreign exchange liability to external creditors.

The American supervisory authorities agree to classify Mexican private debt thus treated as constituting "performing loans" on the books of banks in the US.

December 23:

The IMF executive board approves 3-year assistance of the equivalent of about $3.8 billion under the Fund's Extended Finance Facility and Mexico's first credit tranche.

1983

February 10:

The Mexican central bank disburses to international banks an initial $60 million in payment of arrears of service on behalf of Mexican private sector debtors.

February 24:

Loan agreements are drafted in New York for $5 billion of complementary financing to be provided by about 1,000 international banks on the terms proposed on December 8th.

February 28:

Mexico proposes a restructuring of non-guaranteed public and private sector commercial debt as well as of officially guaranteed private sector commercial debt owed to the international banking system. Principal and interest on suppliers' credits contracted before December 20th, 1982 and falling due up to June 30th, 1983 may be deposited in dollars obtained at a controlled exchange rate by borrowers at the Bank of Mexico. The central bank undertakes to make payments to foreign creditors on conditions to be decided after July 15th, 1983 in the light of the foreign exchange then available and the maturity and size of the outstanding debt. The terms are then to be announced on August 15th – representing the date to which the original moratorium on public sector debt is subsequently set to expire. In restrospect, this is viewed by the market as the first intimation of a subsequent restructuring negotiation in the late summer of 1983.

March 17:

The Mexican authorities ask for an extension from March 23rd to August 15th, 1983, of the moratorium originally declared on August 23rd, 1982 and extended on November 23rd on $19½ billion of principal repayments due to international banks on Mexico's public sector debt to the end of 1984.

April 6:

The Bank of Mexico announces that schemes to cover a total of $15 billion of private sector external debt to banks and other foreign creditors will incorporate earlier proposals but will apply only where creditors agree to restructure the principal over a minimum of 6 years with 3 years' grace. Service on this debt is to be paid into the Bank of Mexico by debtors and the foreign exchange risk is to be covered by a Mexican government trust fund. Applications from debtors and creditors to take part in this scheme will be received up to October 25th, 1983 – another indication that debt renegotiation may become protracted.

April 12:

The terms proposed on December 8th, 1982 for $5 billion of complementary financing and the restructuring of $19½ billion of public sector debt still not approved. The latest date for their approval is officially reported to be August 15th, 1983.

April 15:

M. Michel Camdessus, the Chairman of the Paris Club, formally telexes the Mexican authorities for clarification of their treatment of officially guaranteed private sector debt.

April 21:

Mexico and Spain sign an MOU, or memorandum of understanding, covering the refinancing of all Mexican private and sector debt owed to Spain (other than non-guaranteed loans owed to banks).

April 26-29:

At the Mexican-Brazilian presidential summit meeting in Cancun, Mexico, to discuss bilateral economic relations, the authorities of both countries deny press reports that the meeting was "to discuss a contingency plan ... to join forces in pressing the IMF and the world's banks into accepting their own more favourable terms for repayment of their foreign debt".

May 6:

The finance minister, Mr Silva Herzog, telexes M. Camdessus with formal proposals to refinance all officially guaranteed private sector debt outstanding at December 20th, 1982, over a minimum of 6 years.

May 23:

The IMF board formally acknowledges Mexico's compliance with all its first-quarter performance targets under the SDR 3.4 billion EFF, or Extended Finance Facility, and approves the second draw-down of SDR 301 million (about $3.7 billion and $340 million respectively).

May 24:

Drawings effected by the Bank of Mexico under the three tranches of the $925 million BIS bridging facility are renewed until August 23rd, 1983, on which date the facility expires.

May 31:

The Bank of Mexico makes an advance repayment of $160 million against the BIS bridging facility, leaving a balance of $765 million outstanding.

June 3:

Mexico draws the $340 million EFF financing approved on May 23rd.

Brazil's debt restructuring, 1982-83

1982

August:

From late August Brazilian banks begin losing deposits in the international interbank market. Subsequently, the authorities delay announcing a drop of almost $2 billion in official reserves during September.

October 25:

The Brazilian government announces that after the federal assembly elections on November 15th, it will seek conditional IMF assistance and a "jumbo" medium-term Eurocredit of an undefined amount, but sufficient to keep it out of the markets for six months.

November:

The president of the central bank visits Washington and New York to try to arrange between $2 and $3 billion of short-term bridging finance from US banks and goes on to London, Frankfurt, Zurich and Paris to seek matching assistance from European banks. However, no new financing is immediately forthcoming as a result of these visits. During this period, Brazil makes its first approach to the IMF.

November 26:

The finance minister says Brazil is seeking an agreement with the IMF, but gives no details and the statement is interpreted internationally as one made mainly for its "demonstration effect".

November 30:

The central bank telexes 15 international commercial banks, modifying its request for up to $6 billion of bridging finance sought in the US and Europe earlier in the month, to a request for $2.4 billion of bridging finance to the end of 1982. Again, there is no immediate response.

December 1:

The US Treasury announces the provision of $1.2 billion of bridging finance to the Brazilian Treasury, pending the agreement of a programme by Brazil with the IMF.

December 12:

The Brazilian authorities announce that an agreement in principle has been reached with the IMF and that a letter of intent will be published on the 17th, but the amount of IMF assistance being sought is not indicated.

December 17:

Letter of intent published indicating that more than $5 billion is being sought from the IMF.

December 20:

The president of the Brazilian central bank makes four requests of four groups of commercial bankers at the Plaza Hotel, New York:

(i) provision of $4.4 billion of new money to cover Brazil's anticipated financing needs for 1983, on proposed terms of 8 years, including 2½ years' grace, a fee of 1½ per cent and a margin of 2⅛ rising to 2½ per cent over Libor, or a margin of 1⅞ rising to 2¼ per cent over US prime;

(ii) rescheduling of $4 billion of principal repayments due in 1983 on public and private sector external debt on the same terms as proposed for the new financing in (i), above;

(iii) restoration of trade-related short-term credit lines to $10 billion, representing their level at June 30th 1982;

(iv) restoration of interbank deposits to their level at June 30th, or December 31st, 1982, whichever is higher. Unlike the Mexican authorities, those in Brazil did not act to stem a contraction of interbank deposits, which fell from about $10 billion at mid-1982 to about $6½ billion by the end of the year, with a further fall to about $5½ billion by mid-February 1983. Instead, Brazil was here trying to claw back interbank money. By June, 1983, interbank lines had still not been restored to more than about $6 billion.

At the Plaza meeting, four distinct groups of 11 banks each were formed to pursue each of the four objectives outlined with about 700 international banks. Morgan Guaranty led a group to pursue objective (i), Citibank to pursue objective (ii), Chase Manhattan (iii) and Bankers Trust (iv).

December 24:

BIS approves $1.2 billion of bridging finance to be repaid in equal instalments at the end of February, May and August 1983.

December 31:

Approval is announced of $2.2 billion of bridging finance from American, European and Japanese banks, as a result of requests made during the course of November, initially for up to $6 billion, later modified to $2.4 billion. The terms are 1 per cent over Libor, or ¾ per cent above prime, for 90 days.

1983

January 3:

Brazil announces that it will suspend all repayments of principal due in 1983 on public sector medium and long-term debt, officially estimated at $4.7 billion, compared with an earlier estimate of $4 billion. This unexpected announcement takes the place of the rescheduling proposed as objective (ii) at the Plaza Hotel only two weeks earlier and is read by the financial community as a shift from the "market approach" attempted by Brazil thus far.

January 6:

Letter of intent signed with IMF.

January 24:

The first centralized liaison committee of banks newly formed to replace the four distinct groups of 44 banks created a month earlier, meets in

London. Some of the 16 banks invited do not attend, while others send representatives uninvited because of their membership of the four groups created previously. Because interbank lines to Brazil are not being restored as hoped, this meeting decides that names of recalcitrant banks will be published if necessary to ensure a sufficient response to objective (iv), as set out at the Plaza meeting on December 20th.

January 24:

The managing director of the IMF says he will not recommend Brazil's request for assistance to the Fund's executive board unless interbank lines to Brazil are restored in full to the level of about $10 billion outstanding at mid-1982, as under proposal (iv) at the Plaza meeting. This marks a distinct shift by the IMF in making complementary financing by commercial banks a condition of its assistance, as in the case of Mexico.

January 26:

The Saudi Arabian Monetary Agency, SAMA, announces $250 million of bridging finance to complement the $1.2 billion of BIS financing approved on December 24th; the SAMA contribution is drawn down at once.

February 7:

The Brazil liaison committee, meeting in New York, modifies the requirement that interbank lines be restored in full to the approximately $10 billion outstanding at mid-1982, requiring instead that the total be restored only to 87 per cent of that level.

February 18:

Brazil requests a postponement of the first repayment of $400 million due to the BIS at the end of February; the BIS agrees to accept a postponement only to March 15th.

February 25:

At a meeting with the liaison committee in New York agreement is signed providing $4.4 billion of new financing for 1983, representing the achievement of objective (i) set at the Plaza Hotel meeting on December 20th. Agreement is signed also on the rescheduling of $4.7 billion of 1983 repayments of principal on public sector medium and long-term debt, suspended on January 3rd. The terms of the new financing and the rescheduling are for 8 years, including 2½ years's grace, a fee of 1½ per cent, and a margin of 2½ rising to 2½ per cent over Libor, or 1⅞ to 2¼ per cent above US prime, at the borrower's option.

February 28:

Following the agreements signed with commercial banks three days earler, the IMF approves $4.8 billion of financing under its Extended Finance

Facility, or EFF, and under Brazil's first credit tranche, plus another $550 million under its Supplementary Financing Facility, the SFF.

March 3:

The US Treasury announces a new $400 million bridging facility until the first drawdown of the $4.4 billion of new financing agreed with commercial banks on February 25th.

March 10:

Brazil makes its first drawing of $2.5 billion on the $4.4 billion arranged with commercial banks on February 25th and repays in full the $400 million obtained from the US Treasury on March 3rd. At the same time, commercial banks agree to defer until the end of 1983, repayment of half the $2.2 billion of bridging finance they provided under the agreement of December 31st.

March 15:

The first repayment of $400 million is made to the BIS as due, under the two-week postponement agreed with the BIS on February 18th. This reduces to $800 million the $1.2 billion of bridging finance from the BIS announced on December 24th. Under the original arrangements, the remaining repayments of $400 million each fall due at the end of May, and August, 1983.

May 6:

After weeks of speculation, the authorities admit that end-March IMF programme targets have been breached.

May 18:

The authorities conceded that the second tranche of IMF funds, totalling some $400 million and due from May 31st, will be delayed.

May 24:

Banks decide to postpone a further, disbursement of $634 million of their $4.4 billion loan, owing to Brazil's non-compliance with its IMF programme.

June 7:

The Bank for International Settlements announces that a further repayment of $400 million under its facility to Brazil, due on May 31st, has been postponed until the end of June.

June 9:

The authorities introduce a package of measures to cut the federal budget deficit further, from 5.8 to 3 per cent of gdp. In 1981-82, the total public sector deficit had been more than 12 per cent of gdp.

The Paris Club

The Paris Club is the forum within which countries negotiate the restructuring of public sector debt owed to the 17 governments of the DAC, or Development Assistance Committee of the Organization for Economic Cooperation and Development, the OECD.* Debt restructured in this forum consists of loans from the creditor governments, and private export credits which are guaranteed or insured by export credit agencies in the creditor countries.

The origins of this forum go back to the restructuring of some Argentinian debt in 1956 and again in 1961 and 1962, when some Brazilian debt was similarly restructured. The Club has no written rules, but a set of procedures has developed on the basis of trial and precedent over the years. Although the 'club' has met at premises provided by French Treasury from the first, its creditor country members hesitated until 1974 before appointing a small secretariat to which debtor countries might make their first approach, for fear that the very existence of such a secretariat might encourage more applications for debt rescheduling.

The Paris Club came into being because creditor countries wished to establish common terms and conditions for debt restructuring applications, instead of attempting sets of bilateral arrangements with debtor countries and this, indeed, was perceived by the debtor countries as being in their own interests as well.

From a fairly early stage creditor governments met on their own to decide the merits of applications for restructuring and they still do so. But initially the creditor governments themselves judged whether debtor countries were making adequate efforts to adjust their economic policies, although that task has been allotted to the International Monetary Fund from the mid-1970's. Under the procedure as it now exists, meetings of the Paris Club are convened to consider restructuring application only after the debtor country has first agreed an adjustment programe entitling it to the use of conditional upper credit tranche financing from the IMF.

In terms of procedure, some fairly rigid rules have evolved. Once an IMF programme has been agreed and a restructuring application accepted for consideration, an oral presentation is made by the debtor country in Paris explaining the origins of its problems, the adjustment measures being taken and the terms of relief being sought. Representatives of the IMF discuss the adjustment policies already adopted, representatives of the World Bank evaluate the country's longer term development strategies and prospects, and representatives of UNCTAD, the United Nations Conference on Trade and Development, attend as 'friends of court' for the applicant country.

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* The members of the DAC are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, New Zealand, Norway, Sweden, Switzerland, the UK, US and the Commission of the European Economic Communities.

With few exceptions, relief has been confined to the restructuring of repayments of principal falling due within the 'current period' of up to 2½ years, including the time at which debt relief is requested. Repayments of such principal is commonly allowed to be stretched over an extended period of 8 to 10 years, the first half of which is usually conceded as a 'grace period' during which no principal repayments are required. However, creditor countries usually insist that interest payments be maintained and indeed at a 'moratorium rate'. This is a market rate of interest and is usually above that at which the loans were originally contracted, although it can sometimes be below the original lending rates.

Compromise has evolved out of a long difference of opinion between debtor countries seeking long term 'structural relief' and the opposite view consistently put forward by creditor governments, that the debtor countries should adjust promptly and that relief should be given only to the extent necessary to tide borrowing countries over short-term 'liquidity' difficulties.

The compromise is that creditor countries of the Paris Club have come to agree to consider future requests for debt relief under a 'good will clause' provided that the debtor country continues to meet in full the adjustment programme agreed with the IMF and that new restructuring will be considered only for debt which has not previously been the subject of relief.

Over the years, Paris Club agreements have come to include two provisions intended to provide equal treatment for all creditors. The agreements require that debtor countries should seek to restructure debt to non-DAC governments and private creditors, essentially international commercial banks, on terms no more favourable to such creditors than those agreed with the DAC. While those requirements have tended to be met in more cases, they are still not met in all. Debtor countries are required, in practice, to show that they have sought to restructure debt to non-DAC creditors but not, necessarily, that they have succeeded in doing so. This means that sometimes non-DAC debt continues to be fully serviced.

Until 1978, commercial bank debt restructuring agreements linked formally to Paris Club reschedulings or those which informally took place at about the same time were confined to countries that were indebted only partly and in most cases only marginally, to the banking system and whose external debt was in any case minimal in terms of the global banking system's international assets, let alone total assets. The first breaking of this pattern came with the renegotiation of large amounts of Turkish debt to the banking system from 1979 onwards. It was only in 1982, however, that countries externally indebted mainly to the banking system restructured external debt to banks without having approached the Paris Club. Poland led the way, followed by Mexico, Brazil, Argentina, Chile and Uruguay among others.

The approach of commercial banks to the restructuring of sovereign debt has been influenced by practices which have evolved over the past 25 years, although mainly since the mid-1970's. Up to the latter point, the banks tried to confine themselves on the whole to 'refinancing', a term which has now acquired a wider and imprecise connotation, but which was then applied narrowly to the provision of new money which would allow countries in difficulties to go on servicing existing commitments while adjusting their economies. This had the advantage of allowing the creditor banks to continue classifying all such assets, both old and new, as 'performing loans' producing a stream of income. Rescheduling, meaning the granting of new terms for the servicing of existing obligations, was long resisted.

Even during the period when they succeeded in confining themselves to the refinancing of the external debt of troubled countries, as defined above, banks required debtor countries to demonstrate that they were adjusting their economies to bring their balances of payments under better control. However, they did not seek to suggest formally, let alone impose, adjustment policies until 1976, when the financial community required the government of Peru to submit proposals for an adjustment programme and insisted that the financing provided be disbursed in two tranches, to ensure that the programme was being implemented as planned.

Two years later another innovation took place of which Peru was again the subject. Breaking with precedent, commercial banks agreed to restructure a sovereign borrower's existing debt instead of confining themselves to the provision of new money through 'refinancing' which would permit maintenance of service on outstanding liabilities, pending adjustment. Under two agreements during 1978, Peru's external banking creditors agreed to stretch out all principal payments falling due in 1979 and 1980 and some of those falling due in the second half of 1978, for a period of six years. Subsequently, however, Peru found itself able to repay the principal in a shorter period than agreed under the rescheduling, and took this option to obtain new money at less than the penalty lending margins which applied to the stretched out principal repayments.

On the whole commercial banks have tried to confine themselves, like the DAC governments in the Paris Club, to the restructuring or stretching out of the repayment periods of the principal owed to them by foreign borrowers.

The banks have specifically resisted consolidating arrears of principal payments, the stretching out of repayment periods for short-term debt with an original maturity of up to a year, the consolidation of interest arrears and the restructuring of interest payments. However, since 1979 the banks have found themselves obliged to compromise in all those respects in the case of several countries including Turkey, Nicaragua, Togo, Poland, the Sudan and, more recently, a number of others.

The Institute of International Finance, Inc. (the Ditchley group)

The Insitute of International Finance grew out of a meeting attended by the representatives of 31 leading banks from eight countries in New York on October 27th 1982. These bankers, who had previously informally reviewed international financial issues at Ditchley Park, in Oxford, England, agreed to form an institute to promote the exchange of economic and financial information with borrowing countries. According to a press release at the time, the institute is intended also to 'provide a convenient forum through which individual country borrowers can present to lenders information concerning their borrowing needs'.

By January 1983, the IIF had come into being in embryo form with premises in Washington D.C. for easy access to the International Monetary Fund and the World Bank, which have their headquarters there. In June, 1983, it appointed M. André de Lattre as its first managing director and was also recruiting an initial staff of about 15 economists and professional country risk analysts. The Institute hopes for a membership of about 500 international banks which have or propose to have within the immediate future international exposure in their own portfolios for their own risk. Membership is open to all international banks meeting this qualification, whether privately owned or nationalized. However, membership is not open to non-commercial creditors, development and welfare agencies, or banks which act mainly to syndicate loans to other banks (i.e. investment and merchant banks).

The founders of the fledgling Insitute have been adamant from the first that there is no intention of trying to confront borrowing countries with a united front of international banks and have taken pains to avoid giving any impression of becoming a 'bankers' ramp', both for that reason itself and, at a lesser level, to make possible membership of American banks without risk of breaching US anti-trust laws. The Institute's US lawyers have in fact advised that membership of US banks would not in their opinion breach US law.

Because of its position, the Institute has been at pains to stress what it will *not* do as much as what it hopes to achieve. It will not act as a credit rating agency for countries or act as a bargaining agent for representatives of creditor banks in their dealings with borrowers. It will not make political appraisals of debtor countries or provide a means for collective decision making by member banks. Above all: 'It will not be used for presenting borrowers with a united front', according to the decisions formulated at a second meeting of founder banks in New York in January, 1983.

What the Institute will try to provide is prompt and full information on borrowing countries and it will concentrate on filling information gaps, especially on short-term credits of up to a year. It will seek to present the information in the most neutral way possible to allow member banks to arrive at their own lending decisions, influenced by differences of existing exposure and the views taken by individual banks, which will cause them to react differently to information presented uniformally to all of them.

In pointing to the need for prompter information, especially on short term credits, a spokesman for the Institute said in an interview for this study that such information might have helped bring Mexico's difficulties to light at an earlier stage, thus making them more managable, because individual banks providing more short term interbank funds to Mexico in the months preceding the crisis could persuade themselves that this was happening because they were acting more competitively, in the absence of the knowledge that other banks were similarly increasing their interbank deposits to Mexican banks. The Institute therefore hopes to persuade supervisory authorities like the Bank of England and the Office of the Comptroller of the Currency in the US to make aggregated estimates of short-term credit flows available more promptly on a provisional basis, and would welcome such a development even if the estimates were issued publicly rather than made available to the Institute alone.

The Institute envisages staff missions to borrowing countries which invite such missions. The object will be to gather information on current trends and any information which the host countries may wish to provide on their plans and prospects. It is envisaged that such staff missions will feel less constrained than individual bankers seeking to build up their own lending to the host country and that the attitude of host governments to the missions will likewise differ in some respects from the attitude adopted towards individual visiting bankers. Staff missions may be followed by visits from members of the board of the Institute in the case of countries wishing to discuss their policies, prospects and needs more fully.

Information gathered by missions of staff and directors of the Institute will be made available to the full membership of the Institute as promptly as possible.

While the objective of country missions by a staff envisaged at an initial total of about 15 professionals may sound ambitious, such missions would in fact be concentrated on no more than a handful of sovereign borrowers heavily dependent on commercial bank finance, as distinct from the staff missions regularly sent each year by the International Monetary Fund for consultation with all of the IMF's 146 member countries.

One of the important objectives of the Institute as seen by its founders is to make a full range of information available on equal terms to regional and smaller banks which do not have the resources to gather such information for themselves and whose international lending decisions have often been influenced in the past largely by the view of banks managing international lending syndicates. The hope is that this may give regional and smaller banks the feeling and reality of a closer, more direct and individual role in the international lending process.

Publications

Policy Statement:

The Problem of Exchange Rates
The Group of Thirty

Study Group Reports:

Toward a Less Unstable International Monetary System
The Reserve Assets Study Group

Foreign Exchange Markets Under Floating Rates
The Exchange Markets Participants' Study Group

Balance-of-Payments Problems of Developing Countries
The Capital Movements and the Growth of International Indebtedness Study Group

The Outlook for International Bank Lending
The Capital Movements and the Growth of International Indebtedness Study Group

Reserve Currencies in Transition
Robert V. Roosa, et al

How Central Banks Manage Their Reserves
The Multiple Reserve Currency Study Group

How Bankers See The World Financial Market
International Banking Study Group

Risks in International Bank Lending
International Banking Study Group

Bank Supervision Around the World
Richard Dale

The IMF and the Private Markets
Committee on International Banking

The Future of the International Oil Market
Edwin A. Deagle, Jr.

Occasional Papers:

1. **Exchange Rates, Domestic Prices, and the Adjustment Process**
   Peter B. Kenen and Clare Pack
2. **Credit Creation in the Euromarket:**
   Alternative Theories and Implications for Control
   Alexander K. Swoboda
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8. **Gradualism vs. Shock Therapy**
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11. **Managing Foreign Exchange Reserves in Small Developing Countries**
    Courtney Blackman

The Group of Thirty
Two World Trade Center
Suite 9630
New York, New York 10048
Tel (212) 775-9160

Study group members

Jacques Maisonrouge (Chairman),
IBM

Marina v. N. Whitman
General Motors Corporation

Dirk de Bruyne
Royal Dutch Petroleum

Dennis Weatherstone
Morgan Guaranty Trust Company

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Foreign direct investment 1973-87

FDI trends and outlook

Almost a third of a widely representative sample of major international companies which have cooperated with the Group of Thirty in this study of worldwide foreign direct investment expect their own international investment to increase by more than 25 per cent in real terms during the present five years through 1987. Nearly all of them plan at least some real increase in their global direct investment during that period.

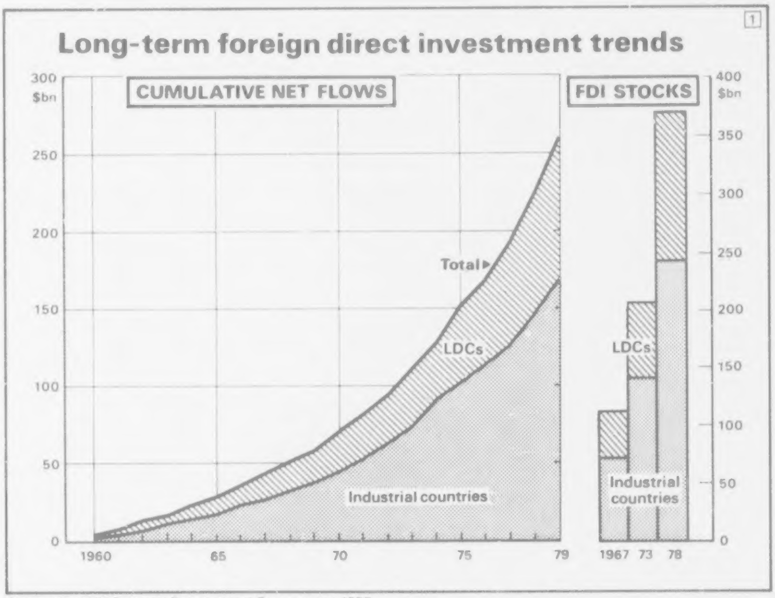
The study is the most comprehensive of its kind yet attempted of the view taken by many of the world's leading international companies of their investment plans and the influences on their investment decisions.

If the intentions reported here are translated into actual investment, there would be some slowing down from the pace of the two preceding five-year periods, during each of which about half the companies participating in this survey increased their real foreign direct investment by 25 per cent or more. However, the real increase planned for the present five-year period by the respondent companies would nevertheless be substantial. And, in relative terms, such investment may come to represent a more important channel for the flow of savings from surplus to deficit countries following the marked contraction of international bank lending to industrial and developing countries since the emergence of international debt-servicing difficulties in mid-1982.

The renewed importance of international direct investment for the world economy justifies public interest after more than a decade during which the contribution of such investment was overshadowed by a growing volume of international bank lending. In the past year, the value of international direct investment has been accorded fresh recognition by President

Reagan, the World Bank and the Organization for Economic Cooperation and Development, among others. As Mr de Larosière, managing director of the International Monetary Fund, said on December 15, 1983: "Foreign direct investment could play a far greater role in resource transfers than in the past."* That recognition has found practical expression, also, in the more welcoming attitude which some developing countries have come to adopt towards international companies. Although about two-thirds of the gross total of international direct investment is made in the mature industrialized countries, the substantial minority of such investment in the broadly defined developing countries tends to make a relatively greater contribution to their economic growth and the growth of their net foreign exchange earning capacity. To quote Mr de Larosière again: "Not only does such investment avoid creating an overhang of debt, it often facilitates the transfer of technology and skills and is directly tied to productive investment."

The possibility that international direct investment may already have started to recapture new importance has been the principal motive for this study by the staff of the Group of Thirty, conducted in 1983 with the generous help of 52 international companies which control and manage almost half the world's stock of foreign direct investment, the total of which is very roughly estimated at between $500 and $550 billion**.


1

Long-term foreign direct investment trends

Derived from UN Centre on Transnational Corporations 1983

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*In a speech to the Economic Club of Chicago.

**A detailed breakdown of the respondent companies by their home countries, industries, aggregate sales and assets is provided on page 18.

This study has been undertaken, also, in the hope of contributing in another way, because direct investment trends and prospects as viewed by international companies themselves have a timeliness and a broader perspective than captured by official data. The World Bank and the DAC, or Development Assistance Committee of the OECD's aid-donating countries*, both concentrate, by the nature of their functions, on the lesser portion of total direct investment flows which go to developing countries. The OECD itself publicly reviews direct investment trends within the industrial countries only periodically (as in "Economic Outlook" No. 32, December, 1982). The UN Centre on Transnational Corporations attempts estimates of direct investment flows on a worldwide basis among industrial and developing countries, but difficulties of collecting and reconciling information from about 150 member countries helps to explain why its published data tend to be four or even five years out of date**. Moreover, some of the published data are logically inconsistent in appearing to show that a large part of international direct investment, as presently measured on a net basis, seems to disappear from the face of the earth. The one recommendation which this report makes is therefore that the importance of international direct investment justifies an improvement in the collection and publication of official information on such investment.

The credence that can be given to a study like the present one depends partly on the extent to which the evidence of the respondents can be reconciled with official data on past trends. In that respect a close relationship can be seen in three important areas.

First, then, the answers to Question 4, possibly the most important in the questionnaire, suggest that the real increase in international direct investment may be significant in the present five years through 1987, even if less than in the preceding five years, because the strong rise reported by respondents for the previous ten years is supported by the available data on gross flows, as shown in Table 1. Because of the deficiencies in data on net flows, for which some explanations are suggested in the "Recommendation" (on page 16), gross flows are probably the best available measure of new international direct investment.

In their answers to Question 4, about 30 per cent of the respondents reported a real increase of 50 per cent or more in their FDI during 1973-77 and half the respondents reported an increase of 25 per cent or more. A still larger proportion of respondents reported increases of those magnitudes from 1978-82, which included the three-year global disinflation which began in 1979. Crudely deflated by US wholesale prices, the real increase in global FDI flows during the decade to 1979 was about 55 per cent, suggesting that some slowing down from that rate would still represent a significant increase in the present period.

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*The members of the DAC are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, New Zealand, Norway, Sweden, Switzerland, UK, US and the Commission of the European Communities.

**"Salient Features and Trends in Foreign Direct Investment", UN Centre on Transnational Corporations, 1983, is based mostly on data going only to 1979 and some going only to 1977.

Table 1
Gross FDI flows
$ millions

Into the following regions:

	U.S.	W. Europe	All industrial countries*	LDCs	Global Total	Percent of total going to LDCs
1960	315	749	2,150	1,806	3,956	*46*
1961	311	1,573	2,815	1,839	4,654	*39*
1962	346	1,598	2,790	1,469	4,259	*35*
1963	231	1,819	2,836	1,659	4,495	*38*
1964	322	2,255	3,412	1,819	5,231	*35*
1965	415	2,652	4,227	2,488	6,715	*37*
1966	425	2,878	4,504	2,159	6,663	*33*
1967	698	2,893	4,791	2,103	6,894	*30*
1968	807	2,646	4,735	2,900	7,635	*38*
1969	1,263	3,300	5,928	2,804	8,732	*32*
1970	1,464	4,200	7,522	3,689	11,211	*33*
1971	367	4,892	7,523	3,307	10,830	*31*
1972	949	5,925	8,702	4,234	12,935	*33*
1973	2,800	8,054	11,688	4,719	16,407	*29*
1974	4,760	9,962	16,965	1,123	18,088	*6*
1975	2,603	7,244	11,153	10,494	21,647	*49*
1976	4,347	5,611	10,791	7,824	18,615	*42*
1977	3,338	8,972	13,851	9,500	23,351	*40*
1978	7,900	10,470	20,978	11,154	32,132	*35*
1979	9,730	9,403	22,098	13,491	35,589	*38*
						35**

Source: UN Centre on Transnational Corporations, 1983. *Besides flows into the United States and Europe includes mainly those into Canada and Australia. Flows into Japan averaged well below $100 million a year throughout. **Average for period.

Secondly, Table 1 seems to support the views expressed by a number of respondents on the infuluence of exchange rate changes on direct investment and the lure of "safe" locations. From 1970 through 1979, the dollar's effective or trade-weighted exchange rate declined steadily by just over 20 per cent, on the International Monetary Fund's calculations. After a lag, that longer-term exchange rate *trend* produced a reversal of the *défi Américain* by attracting an increasing volume of gross direct investment flows into the US. However, the steep rise in dollar interest rates which contributed to a 26 per cent recovery in the effective dollar exchange rate from 1980 to 1982 had a very different effect in attracting huge intra-company financial flows. Some companies interviewed denied strongly that they deploy cash balances as international investment portfolios. That, however, is clearly untrue of some. The British subsidiary of a major American international company recorded almost as much pretax profit from interest on funds lent to its US parent as it did from a successful sales record in 1982. The secretariat of the OECD remarked at the end of 1982:

> "Direct investment to and from the United States recently appears to have behaved somewhat more like financial capital; large interest differentials in favor of the United States and expectations of a strong dollar reportedly resulted in heavy foreign borrowing and repatriation of funds by United States corporations through their subsidiaries and financial affiliates"*.

In summary, longer-term exchange rate trends do seem to influence foreign direct investment flows, while short-term exchange rate fluctuations seem to stimulate intracompany financial flows, but not necessarily a corresponding investment in new plant and equipment (which fits with the answers of several respondents to our question on "the influence of exchange rates" summarized on page 36).

Third, the published data confirm the large proportion of foreign direct investment concentrated in the mature industrialized countries. The companies which cooperated in this study have held about 75 per cent of their total foreign assets in the mature industrial countries since 1977 (compared with just over 80 per cent in 1972 and an anticipated 77 per cent by 1987). Table 1 shows that during the 20 years through 1979, an average of 35 per cent of total international direct investment flows went to the developing countries. While it is true that stocks and flows are not identical, the discrepancy between the 35 per cent of FDI flows reported as going to LDCs and the approximate 25 per cent of their own FDI stocks reported by the companies cooperating in this survey as being held in the LDCs, has two explanations. One is that the proportion of new FDI financed locally is relatively smaller in the LDCs, thus explaining relatively larger flows into them, as compared with the level of their FDI stocks. Secondly, companies engaged in the exploitation of natural resources are less fully represented among those cooperating in this study than they are in the totality of international investment in LDCs.

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*OECD "Economic Outlook", December 1982, p. 57

The consistent contribution that FDI flows have made to developing countries is especially important. Although FDI flows declined from almost 60 per cent to only 20 per cent of net private flows to LDCs during the 20 years to 1980, they are now projected to rise again to about a third of private flows by 1984. On one set of World Bank projections, they could rise to 40 per cent of private flows by 1995*. Those changes and projected changes partly reflect fluctuations in the relative importance of other capital flows, especially bank lending. But underlying those relative changes is an almost consistent contribution of about 20 per cent made by foreign direct investment flows to the total of net capital flows to LDCs.

Summary Table A (Questions 1 and 2)

FDI trends during the recent recession in:

	respondents' companies	respondents' industries
	(per cent of respondents)	
"substantial" increase	*44*	*28*
"some" increase	*29*	*38*
no change or decrease	*27*	*34*
	100	*100*

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*World Bank Development Report, 1983, IBRD, July 1982, p. 33.

Main findings

Against that background, some of the main findings and implications which seem to have emerged from this study can be summarized as follows (for detailed tabulation, see "Analysis of responses" from page 18):

- FDI flows not only *went on rising during the recent recession*, but actually increased more rapidly during the five years through 1982 (which included three years of recession) than during the preceding five years. The implementation of previously planned investment provides one explanation. The impetus given to foreign investment by flat or falling demand in companies' parent countries and a tendency of trade barriers to promote foreign manufacturing as an alternative to exporting are other explanations. Investment into the United States was particularly strong (from other data it is estimated that the stock of FDI in the United States increased from $35 billion at the end of 1977 to $90 billion at end-1981).

- Further evidence of the maintenance of FDI flows during the recession of the three years through 1982 emerges from answers to Questions 1 and 2. More than 70 per cent of the respondents said their own *FDI had increased during that recession* and 66 per cent of the respondents said they believed the FDI of competitors in their industries had likewise increased.

- A maintenance of high rates of growth of FDI flows during the latest five years is suggested by the answers to Question 4 and supported by the data on net flows of the main industrial countries, summarized in Table 3 on page 17, and of FDI flows to LDCs, shown in chart 1 and chart 2, at nominal and real values respectively. The summary table B of answers to Question 4 shows that 56 per cent of respondents reported an increase of more than 25 per cent in their FDI in real terms during the five years through 1982, compared with 49 per cent which reported a similar increase during the five preceding years. However, the table suggests also a slowing down in the present five-year period, when only 29 per cent of respondents expect their real FDI to go on rising by more than 25 per cent. Nevertheless, 85 percent of the respondents still expect some real increase in their FDI during the current period. Since this survey was conducted before the present global economic recovery had fully started and when real and nominal interest rates were still above recent levels, the actual outturn for FDI during the current five years may prove better than suggested here, if the world economic recovery is sustained and if the cost of money falls further.

- The answers to Question 6 show that the number of respondent companies reporting a "pronounced increase" in their FDI during the largely

Summary Table B (Question 4)

Estimated and anticipated changes in real FDI

	1973-78	1978-82	1983-87
	(per cent of respondents)		
increase of:			
more than 50%	*31*	*36*	*9*
25-50%	*18*	*20*	*20*
up to 25%	*41*	*34*	*56*
no change or decrease	*10*	*10*	*15*

Note: It will be seen that the 27 per cent of respondents reporting "no change or a decrease" in their FDI "during the recent recession" in answer to Question 1, is very much larger than the 10 per cent giving the same answer to Question 4 above, part of which spans the five years through 1982 which includes two years of relatively rapid global economic growth in 1978 and 1979. That suggests some slowing down from 1980.

recessionary period of 1978-82 reported such an *increase in nearly all groups of countries* covered, namely the mature industrialized countries (the MICs), the newer industrialized countries (NICs) of Europe, Asia and South America, as well as in the less developed countries (LDCs); see page 23. Significantly, some maintenance of FDI is expected also in South America and, if that materializes, it will provide relatively more important channel for development capital to that region, where debt-servicing difficulties have been especially concentrated.

- However, two aspects deserve mention here. Firstly, much of the new FDI envisaged by respondents is expected to be concentrated in *new industries,* particularly high-technology. A second, related point, is that this survey has been produced almost exclusively with the help of *major international companies.* While these do include some of the most prominent high-technology firms, many of the smaller international companies in new fields are not included in the survey, nor are smaller international companies as a whole, whose combined influence on FDI trends may nevertheless be important at the margin. Among many possibilities this raises is that new FDI may prove larger than suggested by the answers in this study (for further information on our sample, see page 18).

- *The partly counter-cyclical trend of FDI* flows was brought out by many respondents in their comments on questions 1-4. In this respect they mentioned shrinking opportunities in their home markets, the need to compete more efficiently in host countries, the need to overcome a proliferation of nontariff trade barriers during recessionary periods, and the greater receptiveness of broadly defined developing countries to FDI at times of recession. Some comments under this heading included:

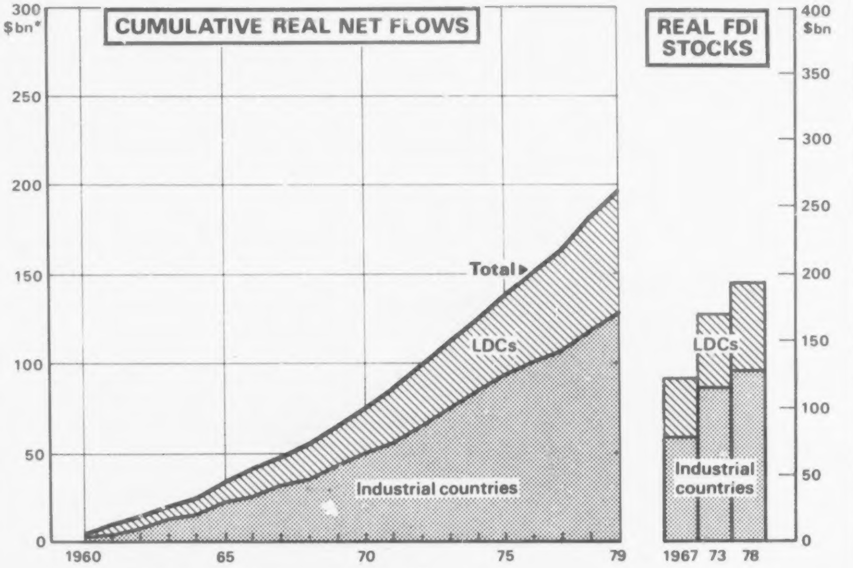
> "The poor rate of profit at home, compared with foreign opportunities."
>
> "Restrictions on economic growth by recession are seen to be counterbalanced by extending our group's presence into new localities."
>
> "Investments are made as a hedge against local competition, which is even fiercer in a recession."

However, some other influences were also mentioned as helping to maintain *FDI flows in bad times and good.* Among the comments here were, "Spending commitments are often long-term and irreversible, especially in capital-intensive industries" and "Current expenditures probably anticipate future market recovery and expansion". In the same vein, "The long term economic outlook in many countries continues to remain favorable."

- Several respondents attributed the *growth and planned growth* of their FDI to the fact that they specialized in "growth industries" like office machinery and high technology products. Indeed the survey yielded impressionistic evidence that FDI will increasingly be spearheaded by companies in such fields.

2

Real long-term foreign direct investment trends



*Crudely deflated by US $ wholesale index (1970 = 100)

Derived from UN Centre on Transnational Corporations, 1983

Table 2

The financing of current deficits for all developing countries, 1982-95

	Billions of current dollars		Annual percentage growth		
	1982[a]	1995	1970-80	1980-82	1982-95
Current account balance[b]	-118.2	-276.2	*17.2*	*41.7*	*6.7*
Net capital flows	85.2	294.2	*20.4*	*2.2*	*10.0*
Official development assistance	23.9	81.2	*17.9*	*-1.0*	*9.9*
Official nonconcessional loans	11.0	42.0	*24.5*	*5.6*	*10.9*
Private loans	35.0	109.6	*22.3*	*-0.4*	*9.2*
Private direct investment	15.3	61.4	*18.6*	*12.5*	*11.3*
Use of reserves and other capital[c]	33.0	-18.0	. .	. .	. .
Memorandum items					
Debt outstanding	548.0	1,996.8	*19.9*	*13.7*	*10.5*
Official	199.0	809.8	*16.5*	*12.5*	*11.4*
Private	349.0	1,187.0	*22.3*	*14.3*	*9.9*
Resource gap as percentage of GNP	*3.7*	*1.6*	*n.a.*	*n.a.*	*n.a.*
Current account deficit as percentage of GNP	*5.0*	*2.7*	. .	. .	. .
Net capital flows as percentage of GNP	*3.6*	*2.9*	. .	. .	. .
Debt service as percentage of GNP	*4.7*	*3.5*	. .	. .	. .
Debt service as percentage of exports	*20.7*	*12.0*	. .	. .	. .
Interest payments as percentage of GNP	*2.1*	*1.5*	. .	. .	. .
Deflator[d]	95.7	213.8	*10.3*	*-1.6*	*6.4*

n.a. Not applicable.
. . Not available.
a. Estimated.
b. Excludes official transfers.
c. Short-term borrowing.
d. US dollar GDP deflator for industrial countries.
From: *World Development Report, 1983*, p. 33, 34, covering 102 LDCs.

- Within the MICs, where FDI is still largely concentrated, flows have been stimulated in recent years and continue to be by the quest for what several companies have termed *"safer locations."* But another factor is the persistence of nontariff barriers like requirements for different standards within the European Community. A non-EEC international company said its original hopes of rationalizing its European production had been frustrated partly by the persistence of such barriers, although it mentioned also differences of national markets.

- An important aspect of flows to developing countries broadly defined is that even when relatively small in terms of total FDI flows, they nevertheless represent *large inflows for the host countries.* Direct investment capital flows from the DAC countries to developing countries rose fourfold over 11 years to more than $14½ billion in 1981 in nominal terms, an increase of about 55 per cent in real terms (see chart 3)*. The findings of our survey are consistent with the projection of the World Bank that the share of FDI in total private flows to LDCs may increase sharply in the years to 1995. (Movements in the share of FDI in past capital flows to LDCs are shown in charts 4 and 5)

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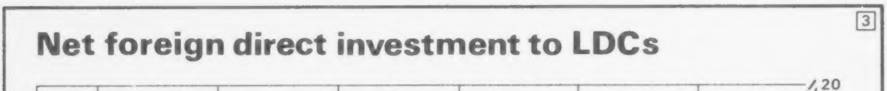
*Development Co-Operation, OECD, 1982, page 178.



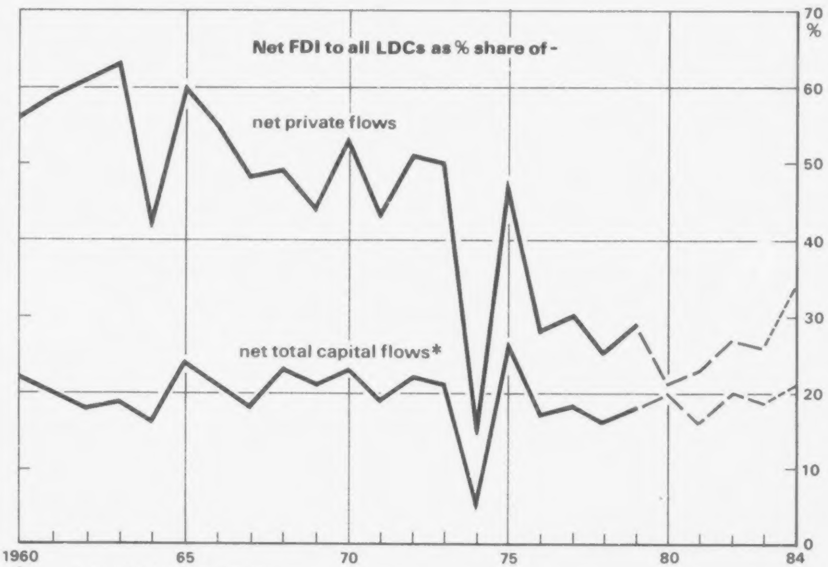
Net foreign direct investment to LDCs

*Crudely deflated by US wholesale index

Source: OECD DAC 1983 for 1971-81, other international estimates and forecasts for 1982-84

- Another conceptual difficulty is raised by the growing practice of some international companies of subcontracting work, like the making of parts, to independent companies in foreign countries. This can be called *foreign direct investment without investment* because it does not represent FDI in the accepted sense. In such cases, the international company has no equity in the subcontractor. However, the practice does have some of the economic influences of FDI. Where the international company is the subcontractor's biggest single or only customer, as often happens, the local company has in effect been brought into existence and is kept in being by the international company. In this way, the international company creates, in another country, a new enterprise, employment and also the generation of new foreign exchange earnings for the subcontractor's country of domicile. Yet the international company achieves all this without going through the motions of conventional foreign direct investment or incurring the same kind of risks as those attaching to conventional FDI. Moreover, loan capital, where provided to a foreign subcontractor by an international company, has an arm's-length quality which does not attach to loan capital supplied by an international company to a foreign subsidiary. However, it does have a similar economic effect in providing a capital inflow for the subcontractor's country of domicile, releasing an equivalent amount of domestic savings in that country for alternative investment, though at the same time imposing a

The foreign direct investment contribution to LDCs 4



* from all official and private sources

Sources OECD 1960-79, provisional estimates and forecasts for 1980-84 from other international sources foreign exchange liability on the balance of payments of the subcontractor's country. In summary, the economic and balance of payments effects are almost identical to those of FDI, but this growing practice is not captured in FDI data, and rightly so because it is not FDI in the accepted sense. It is, however, a manifestation in another form of the economic contribution made by international companies.

- An aspect of FDI flows raised, but not at this stage clarified by the survey, is the extent of real and apparent disinvestment. *Disinvestment* by some international companies in some parts of the world, notably Latin America, has recently been reported, and has been attributed partly to recessionary losses abroad and partly to the need of parent companies to rebuild balance sheets and liquidity. However, very few respondents to this survey reported a decrease in their real FDI during the latest five years to 1982 nor did they foresee any during the present five years to 1987 (see page 22). The apparent contradiction is partly explained by the fact that some apparent "disinvestment" proves to have represented *intracompany borrowing* to take advantage of interest rate differentials, particularly borrowing by US head offices from foreign subsidiaries.

- An aspect of FDI which is obvious enough but underscored by this survey is that the influences are different for different types of companies. Those specializing in the *exploitation of natural resources* are obviously drawn to where the resources are. One of the most interesting observations to emerge from interviews was made by an international minerals company which said that it did not have either the financial resources or the technical expertise to offset or ride out the commodities' cycle in metals. It said it was just beginning to try to form a longer 6 to 10 year view, but its present time horizon stretched to 5 years at most. Within that span it tends to invest when metal prices are high and to cut back new spending when metal prices are depressed, in spite of thus adding, together with competitors, to the familiar *commodities' cycle* of overinvestment, glut, underinvestment and scarcity.

The impressionistic view conveyed above is reinforced by the answers of the (admittedly small and statistically insignificant) number of natural resource companies which answered Question 4. Their rate of new FDI rose strongly in the boom period of 1973 to 1977, but has slowed since then and the companies expect flows to slow down still more in the present five years to 1987. Unlike FDI by some other industries, that of natural resources companies does not appear to be countercyclical.

- The answers to Question 9 bring into sharp focus the main *influences on FDI decisions. Access to the host country's domestic market* is by far the most important in the industrialized and developing worlds, followed by *access to regional markets* (for MICs) and avoidance of tarriff barriers (for LDCs). Integration with existing investment is also an important influence on new FDI in the MICs, but less so in the LDCs. Changing industrial structure, and slower growth of home markets, and the avoidance of nontariff barriers to trade follow. For an impression of our respondents' views of the *changing climate for investment*, both by region and industry, see answers to Question 10.

- The factors which do not influence FDI, or hardly so, are as interesting as those that do. Political stability and labor cost advantage in host countries were ranked by our respondents very low among the influences on FDI decisions; even inducements offered by host countries are rated as marginal, underscoring the point that realistically promising opportunities attract investment themselves. The relative unimportance attached to political stability and labor cost advantage is another contradiction of perceived wisdom. The influence of wide fluctuations in exchange rates and interest rates also appears to be less than often believed, subject to the qualifications already mentioned (Questions 13 and 14).

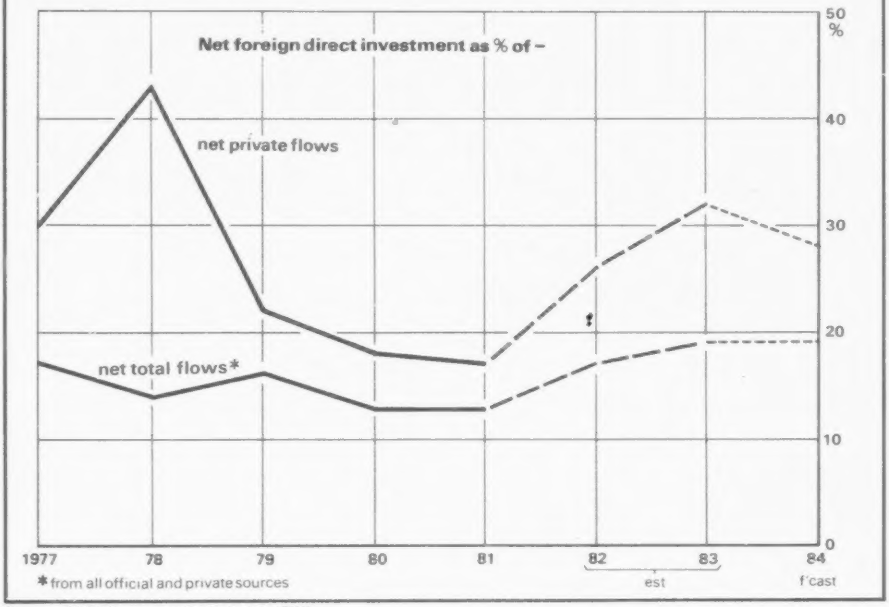
- Increasing emphasis is being placed on *joint ventures*, especially by American companies, and on full acquisitions of foreign companies, especially by European companies in the United States (Question 18).

- Over the past decade the foreign subsidiaries of international companies have been required to stand ever more on their own feet. This is clearly shown in the answers to Question 19 (although it is fair to note that critics accuse international companies of more rhetoric than reality on this score). Since 1973, there has been less reliance on financing provided by parent companies and more on the *retained earnings of subsidiaries, debt, and equity issues in the host countries and debt issues in world markets* (mostly Euromarkets). Interviews reinforce the impression that there has been a relative shift, also, toward more debt and less equity financing of subsidiaries. However, where finance is raised by debt issues by the host country on world markets the impact on the balance of payments of host countries is not clear-cut. Unlike dividend earnings, which tend to rise when business is good, the interest on external debt capital represents a fixed element in the host country's balance of payments in good times and bad. Indeed, it can impose a rising cost, as in the recent past when the price of money rose steeply while world output and trade stagnated. It does not follow, however, that externally held equity is less burdensome for the host country's balance of payments in all cases. This is especially true when international companies aim for a short payback period for recouping their initial investment—and the survey yielded some evidence to suggest that the target payback period was shortening (Question 16). During such a period bunched dividends or remitted profits can make a large if temporary dent on the host country's balance of payments to the extent that there are no impediments to the outflow of remittances from the host country.

- Many companies interviewed said that they detected a tendency towards more realistic and therefore *improved relations* between host countries and international investing companies. The frequency with which the subject was brought up by executives who were being interviewed indicated a continuing sensitivity or at least awareness of the public relations of FDI in the broadest sense, meaning relations with host country governments as well as media.

5

Foreign direct investment to non-oil LDCs



Source: OECD Economic Outlook, July 1983

Recommendation

If the present survey has any recommendation to make, it is to suggest greater cooperation between international companies, national governments and international agencies to contribute to a prompter, more uniform and simpler reporting of FDI flows and stocks. The need for *quicker and better* information has long been recognized and pursued with new vigor in the international banking field, and similar improvements might usefully be made in the case of direct investment. The *difficulties are real and considerable.* "Salient Features and Trends in Foreign Direct Investment", published by the UN Centre on Transnational Corporations in 1983, contains a full annex on the problems of FDI data compilation. It says:

> "Disparities among countries concerning definitions, coverage and methods of compilation of data on FDI place severe constraints on efforts to collect, compare and analyze flows and stocks of such investment at the international level. Moreover, data are lacking in a few developed and a large number of developing countries".

It then goes on for four pages to explain those difficulties, and to explain its own definitions and methods of compilation and comparison, which are not in all respects the same as those used elsewhere. If FDI is indeed to become a more important component in world capital flows, we suggest an improvement in statistical information will be essential.

The need for an improvement in reporting of international direct investment is thrown into especially sharp relief by Table 3 which appears to show, for most years, the net outflow of direct investment off the earth's face already referred to. The reason for the bewildering picture shown seems to lie mainly in a blurring of the distinction between investment and financial flows meaning, in plain language, between money destined for investment in new plant and machinery, or the acquisition, creation or enlargement of a business abroad, and the movement of temporarily idle cash balances to best advantage within international companies.

Another possible explanation is that earnings retained by affiliates may sometimes be recorded as outflows by parent companies, and recorded as such in the balance of payments statistics of the parent companies' home countries, while not being recorded as inflows by the subsidiaries or their host countries.

The result, whatever the explanations, is to make much data on international direct investment meaningless, even to statisticians. The objective should be to make them intelligible for those who make and influence policy, not least international companies themselves.

Table 3

Net FDI flows

$ billions

	U.S.	W. Europe	Japan	LDCs
1960	-2.6	-0.3	—	n.a.
61	-2.3	+0.1	—	n.a.
62	-2.5	0	—	n.a.
63	-3.3	+0.4	—	n.a.
64	-3.4	+0.8	—	n.a.
65	-4.6	+0.7	—	n.a.
66	-5.0	+1.0	—	n.a.
67	-4.1	+0.7	—	n.a.
68	-4.5	0	-0.1	n.a.
69	-4.7	+0.1	-0.1	n.a.
1970	-6.1	+0.5	-0.3	n.a.
71	-7.3	+0.4	-0.3	n.a.
72	-6.8	+0.4	-0.6	n.a.
73	-8.6	-0.3	-1.9	+4.2
74	-4.3	+0.6	-1.8	+5.3
75	-11.6	-0.9	-1.5	+5.3
76	-7.3	-4.4	-1.9	+5.0
77	-7.9	-2.0	-1.6	+5.4
78	-8.5	-3.4	-2.4	+7.3
79	-14.6	-8.3	-2.9	+8.9
80	-5.6	-6.7	-2.1	+10.1
81	+12.6	-24.0	-4.7	+13.9
82	+12.2	-13.0	-4.9	+11.4

Sources: UN Centre for Transnational Corporations to 1979; OECD 1980-81. Japanese net flows less than $100 million until 1968. Net FDI flows of developing countries are not available on the same basis, but are drawn for 1973-1982 from the IMF annual report, 1983 (p.33)

ANALYSIS OF RESPONSES

SAMPLE

This report is based on written answers to a questionnaire by 52 major international corporations in the leading industrial countries and on subsequent interviews with some of them.

Only large international corporations were approached. As foreign investment is known to be carried out principally by large corporations, and as the companies we approached are all leading international investors it is reasonable to suppose that our respondents account, between them, for a significant proportion of total foreign investment worldwide.

Our respondents (excluding financial corporations) had aggregate assets of more than $400 billion and sales of over $550 billion in 1981. The average foreign to total sales ratio (excluding intracompany sales) was 47 per cent, the median being 45 per cent. We estimate that the foreign assets of our respondents are probably in the range of $200-$250 billion. Although not strictly comparable, the total stock of foreign direct investment, worldwide, is estimated at between $500 billion and $550 billion.

Twenty-nine per cent of the respondents said that foreign sales

Number of companies in sample:

Chemicals	7
Food (Including Trading)	5
Motor Vehicles & Allied	5
Electronic, Appliances	3
Office Equipment, Computers, Telecommunications	3
Pharmaceuticals, Cosmetics, Soap	3
Extractive Industries	3
Metal Refining	3
Building Materials	2
Measuring & Scientific Equipment	2
Beverages	4
Financial, mineral and other	12

More attractive outlook

The World Bank's Development Report, 1983 on the outlook as follows:

"Some of the expansion in bank lending over the past decade substituted for private direct investment. This trend was encouraged by the relatively low interest rates through most of the 1970s and by the restrictions host countries placed on direct investments. The restrictions were often a reaction to past experiences of investments that were unnecessarily subsidized or were seen as having been inconsistent with development objectives. For multinational firms, it was often easy to substitute debt for equity."

"The outlook for direct investment has become more attractive recently, since the cost of borrowing has risen and an understanding has been reached between investors and some host governments. Moreover, the outflows related to direct investment—in the form of profit remittances—are directly dependent on the success of the enterprise, and there is more flexibility as to timing. With the prospects for bank lending more constrained, direct investment may contribute a greater share of the capital flows to developing countries. However, the scope for substitution is limited to the private sector; direct investment cannot be used to finance most development infrastructure."

exceeded 60 per cent of their total sales. Twenty-three per cent said that foreign sales represented between 40 and 60 per cent of total sales whereas for 40 per cent of the respondents this percentage was less than 40.

The manufacturing sector accounted for 77 per cent of our sample; 48 per cent manufactured durable goods and 29 per cent consumer goods. Fifteen per cent of our respondents were financial institutions while the rest came from a variety of other sectors.

Our respondents came from 12 countries. About one third were from the United States, one third from Europe and one third from Japan and other parts of the world.

Except where otherwise indicated a large majority of respondents answered the questions. However, the statistical results are not to be interpreted as more precise than the statements in the text of the preceding section and the comments attached to the following tables.

Trends in foreign investment

1. *During the world recession of recent years, has your company's foreign direct investment: increased substantially, increased somewhat, remained about the same, decreased somewhat, decreased substantially?*

Respondents' view of FDI by their company—

per cent

	All respondents	Respondents from manufacturing sector	
		American	European
Increased substantially	44	44	36
Increased somewhat	29	22	43
Remained about the same	23	28	21
Decreased somewhat	2	6	0
Decreased substantially	2	0	0
	100	100	100

2. *During this same period, do you believe that foreign direct investment by other companies in your industry has:*

—and by their industry

per cent

	All respondents	Respondents from	
		US	Europe
Increased substantially	28	24	22
Increased somewhat	38	29	57
Remained about the same	22	29	14
Decreased somewhat	12	18	7
Decreased substantially	0	0	0
	100	100	100

While respondents believe that their own company's foreign investment has grown faster than that of their industry, two-thirds believe that their industry's FDI has increased "substantially" or "somewhat", at a time when aggregate levels of *domestic output* and especially investment have been flat or falling in nearly all of the parent countries.

3. FDI in the recession

In most industries, foreign direct investment seems to have increased despite the world recession. What do you believe to be the main reasons for this?

The major reasons suggested by respondents (ranked by the frequency with which a particular factor was mentioned) were as follows:

1. The momentum of investment plans and protection of existing markets
2. Intensified search for lower-cost sources of production
3. Diversification, both of market risk and currency risk; with some emphasizing foreign investment as a means of overcoming difficulties in pricing exports at times of large exchange rate fluctuations
4. Growth of various forms of protection, notably local content requirements
5. Faster growth or greater profitability of overseas markets
6. Investment in anticipation of an economic recovery
7. Technical progress and application of new technology
8. More receptive attitude of LDCs
9. "The difficulty of divesting in a recession".
10. "The strong dollar", making FDI more attractive for some US corporations

4. Looking to 1987

Please estimate the change in your company's real, or expected real, foreign direct investment (that is, adjusted for inflation and exchange rate changes as far as possible) for the three five-year periods shown below. (Check one box in each column).

Changes in FDI 1973-1987

per cent

	1973-77	1978-82	1983-87
Increase of 50% or more	*31*	*36*	*9*
Increase of 25% to 49%	*18*	*20*	*20*
Increase of 10% to 24%	*31*	*24*	*39*
Increase of less than 10%	*10*	*10*	*17*
No increase or decrease	*4*	*6*	*7*
Decrease of less than 10%	*2*	*2*	*7*
Decrease of 10% to 24%	*2*	*2*	*2*
Decrease of 25% to 49%	*0*	*0*	*0*
Decrease of 50% or more	*2*	*0*	*0*
	100	*100*	*100*

A deceleration from recent very high growth rates is expected in the next few years. But only four companies of 46 replying expect their FDI to decline in absolute terms. Moreover, it should be recalled that the survey was conducted just before the pointers to the present upturn in the US economy had emerged clearly, and just after the imposition of austerity measures in many LDCs that followed their much-publicized debt-servicing difficulties in mid-1982. As a group, Japanese companies clearly intend to increase their investment at a far more rapid pace than our European or US respondents.

Classifying the results by industry, those expecting an increase of 50 per cent or more were in electronics and office automation equipment; those expecting an increase of 25 to 49 per cent were in chemicals, pharmaceuticals, motor vehicles and scientific instruments; those expecting an increase of 10 to 24 per cent were in food, office equipment, extractive industry and motors; but those expecting an increase of less than 10 per cent also included companies in steel, chemicals, motors, and pharmaceuticals.

5. Foreign sales

Excluding any intracompany sales, approximately what percentage of your company's 1982 total sales were foreign subsidiary sales?

47% (average)

The median figure was 45%; the maximum was 97% and the minimum for an industrial company, was 10%.

6. Geographical distribution of new investments

For each group of countries, please indicate the change, or expected change, in your company's foreign direct investment for the three five-year periods below by writing in "more" for a pronounced increase, "less" for a pronounced decrease and "none" for little or no change.

The table on the following page shows that within the slower growth expected in FDI in 1983-87, the following broad trends may be distinguished: the high proportion expecting to invest "more" in Asian NICs; the sharp fall in the proportion expecting to invest "more" in Latin American NICs (but note also the low proportion expecting to invest "less" in the region); and the finding that investment plans in non-oil LDCs other than NICs seem to have suffered less than might have been expected.

Classifying the results by country of respondent:

(a) Japanese respondents are relatively more expansionary in all areas—all expect a pronounced increase in their investment in other industrial economies and none of them expect to invest "less" in any region;

(b) US corporations remain somewhat more expansionary than their European counterparts among our respondents, with a large majority still planning for a pronounced increase in their investment in industrial countries (compared with only a minority of Europeans expecting such an increase);

(c) European corporations appear particularly gloomy about South American NICs, with only one major corporation expecting a "pronounced increase" in its investment there, compared with six American companies;

(d) Companies in all regions appear to have maintained their plans for further investment in nonoil LDCs better than might have been expected—only two industrial corporations said they expected a

FDI Flows by regions

per cent

Flows into:	1973-77 More	1973-77 No change	1973-77 Less	1978-82 More	1978-82 No change	1978-82 Less	1983-87 More	1983-87 No change	1983-87 Less
Mature industrialized countries (MICs)	*74*	*20*	*6*	*84*	*8*	*8*	*65*	*26*	*9*
European newer industrialized countries (NICs): Greece, Israel, Portugal, Turkey, Yugoslavia	*19*	*77*	*4*	*18*	*78*	*4*	*13*	*78*	*9*
S.E. Asian NICs: Hong Kong, Philippines, Singapore, South Korea	*45*	*49*	*6*	*49*	*47*	*4*	*43*	*53*	*4*
South American NICs: Argentina, Brazil, Mexico, Uruguay	*60*	*38*	*2*	*59*	*35*	*6*	*22*	*67*	*11*
Oil-exporting countries	*34*	*60*	*6*	*31*	*63*	*6*	*24*	*72*	*4*
Non-oil exporting less developed countries (LDCs)	*26*	*70*	*4*	*31*	*65*	*4*	*22*	*71*	*7*

"pronounced decrease" in their investments in this group of countries—one European and one Canadian; and while most respondents expect "no change", nine are still planning on a "pronounced increase".

7. Geographical distribution of assets

Please indicate the approximate percentage of your company's total assets in each group of countries at the end of each of the years shown below.

FDI assets by region-summary

All respondents less banks

	1972	1977	1982	1987
Home country	*60.9*	*57.1*	*56.9*	*55.1*
MICs	*32.1*	*32.1*	*32.6*	*34.6*
European NICs	*0.8*	*1.0*	*0.8*	*1.0*
S.E. Asian NICs	*0.6*	*0.8*	*1.3*	*1.5*
South American NICs	*2.7*	*3.7*	*4.4*	*4.3*
Oil-exporting countries	*0.6*	*1.4*	*1.6*	*1.7*
Non-oil exporting LDCs	*2.3*	*2.6*	*2.4*	*1.9*
	100	*100*	*100*	*100*

The results underline the concentration of assets in the mature industrial economies and no far-reaching changes in the existing distribution of assets are contemplated. However, it should be borne in mind that if we are right in our estimate that our respondents manage almost half of the total outstanding stock of direct investment worldwide, even a one percent shift in the distribution would represent a significant sum, especially if switched to or from poorer regions.

Our US respondents have kept the proportion of their assets held at home remarkably steady, at about two-thirds of total assets on average—and no change is expected on balance in this ratio between 1972 and 1987. (Going through the individual responses, few US corporations expect any increase in the proportion of their assets held overseas in the next five years—though again, this is not a true guide to new investment flows, for various reasons, and especially because those that *do* expect a shift may be among those who expect also to invest large amounts).

FDI assets by region-detail

All respondents less banks

Per cent of respondents' total assets held in:

The home country	**1972**	**1977**	**1982**	**1987**
American	*68*	*64*	*67*	*68*
European	*38*	*35*	*32*	*34*
Canadian	*64*	*57*	*49*	*47*
Asian	*90*	*90*	*82*	*74*
The home country and other MICs				
American	*94*	*90*	*91*	*91*
European	*86*	*85*	*84*	*84*
Canadian	*97*	*91*	*92*	*92*
Asian	*99*	*97*	*95*	*93*
European NICs				
American	*0.3*	*0.3*	*0.3*	*0.4*
European	*2.6*	*2.8*	*2.7*	*3.0*
Canadian	*0.0*	*0.3*	*0.0*	*0.0*
Asian	*0.0*	*0.0*	*0.0*	*0.0*
S.E. Asian NICs				
American	*0.8*	*0.8*	*1.6*	*1.8*
European	*1.0*	*1.2*	*1.4*	*1.6*
Canadian	*0.0*	*0.2*	*0.2*	*0.2*
Asian	*0.5*	*0.7*	*1.5*	*2.0*
South American NICs				
American	*3.3*	*4.5*	*5.8*	*5.5*
European	*3.6*	*4.6*	*5.3*	*5.8*
Canadian	*1.3*	*1.8*	*1.8*	*1.8*
Asian	*0.5*	*0.3*	*0.3*	*0.7*
Oil-exporting countries				
American	*0.3*	*0.4*	*0.4*	*0.3*
European	*1.7*	*1.2*	*1.3*	*1.4*
Canadian	*0.2*	*4.0*	*4.8*	*4.7*
Asian	*0.0*	*1.3*	*2.5*	*3.0*
Non-oil exporting LDCs				
American	*1.2*	*1.5*	*1.4*	*1.1*
European	*5.3*	*5.0*	*5.6*	*4.0*
Canadian	*2.0*	*2.5*	*1.3*	*1.2*
Asian	*0.0*	*1.0*	*1.3*	*1.3*

European, Canadian and Asian companies on average reduced the proportion of assets located in the home country between 1972 and 1982, but only the Japanese expect to reduce this much further in the next few years.

Respondents from all regions have held on average more than 80 per cent of their assets in industrialized economies—and all except the Europeans have held 90 per cent or more in such areas (the home country and other MICs). No group (not even the Japanese) expect to effect a large change in this distribution to 1987. This data, accordingly, suggests though it clearly does not prove that a net increase in direct investment in the developing countries must come largely from their share of an increase in worldwide investment, rather than a large change in the distribution of investment in their favor.

With respect to the developing countries themselves, no large changes are expected, on average, by our respondents—though of course the figures refer to very large and heterogeneous groups of countries and therefore hold no message for an individual economy. Perhaps the main feature is the relatively rapid growth expected by the Asian (almost exclusively Japanese) companies in most regions of the world—albeit from a low level; another feature is that no net reduction in the proportion of assets held in Latin America by nonfinancial corporations is expected, despite the caution expressed about the region by many corporations.

Classifying the results by industry, the companies that have reduced the share of the home country in their total assets in the ten years to 1982 are mainly in high technology, motors and allied industries. In general durable goods manufacturers redistributed their assets away from non oil LDCs to the MICs.

8. The geographical distribution of assets, pre- and post-tax profits, 1972-1987

Although the proportion of assets employed in home countries has remained steady or declined, the contribution of the home country to profits (pre and posttax) increased in the ten years to 1982. (US industrial corporations reported an especially sharp change. In 1976, a majority of US corporations reported that the profit contribution of foreign operations was larger than the proportion of assets employed abroad, whereas by 1982 all but one reported the opposite—a greater relative profit contribution by the United States.) True, as several pointed out, comparability is rendered particularly

The geographical distribution of assets and profits, 1972-1987*

REGION	1972			1977			1982			1987		
	ASSETS	PRETAX PROFITS	POSTTAX PROFITS	ASSETS	PRETAX PROFITS	POSTTAX PROFITS	ASSETS	PRETAX PROFITS	POSTTAX PROFITS	ASSETS	PRETAX PROFITS	POSTTAX PROFITS
Home	62.5	63.3	59.8	57.8	66.3	64.4	56.1	66.8	64.4	54.7	60.1	58.5
Mics	31.1	26.9	30.4	31.8	24.8	26.1	33.3	19.8	19.0	35.1	30.2	31.7
Euro-nics	0.7	0.3	0.4	0.9	0.2	0.3	0.8	0.3	0.5	0.9	0.3	0.3
S. E. Asian Nics	0.6	0.4	0.5	0.8	0.9	0.8	1.5	0.8	0.7	1.7	1.9	1.4
S. Amer. Nics	2.4	2.2	2.8	3.4	3.3	2.9	4.3	2.4	1.6	4.0	3.7	4.4
Oil Exporters	0.6	3.0	2.9	1.4	2.0	1.9	1.6	0.7	0.4	1.7	1.2	1.0
Non-oil Ldcs	2.1	3.9	3.5	2.6	2.5	3.0	2.5	2.7	4.6	1.9	2.3	2.9

*The percentage of the sample responding to this question ranged from 42 per cent for some time periods to 70 per cent for others.

hazardous by changes in accounting conventions, differing ways of treating exchange rate gains and profits, the use of "assets" rather than net investment, and by the fact that several corporations were making large worldwide losses in 1982. Nevertheless, we gained the impression that if allowance could be made for such factors, a real change was taking place in relative profitability and thus in attitudes to foreign investment, notably by US corporations.

Depressed economic conditions, especially in Europe, together with the effects of large medium-term exchange rate movements (both on balance sheet and P&L accounts) and changes in the financing pattern were the most frequently mentioned causes of the volatility of the profit contribution of various regions. Investment in LDCs had suffered from the absence of a sufficiently large market to reap scale economies (in all but a few large LDCs). Where profits were high in LDCs, these were frequently attributed to protection against imports, as well as the rapid growth of the markets concerned.

To quote from some replies:

> "The US is the most profitable market primarily because of efficiencies based on volume. Investment abroad is importantly motivated by desire to participate in high growth markets but earnings suffer from lack of volume, excessive regulations and frequently highly competitive markets. Also higher capital costs where local financing is incurred".
>
> "Generally profit margins tend to be lower in Europe and substantially higher in non-MICs. These differences reflect such factors as the attitude of governments to profits, the rate of underlying economic growth, the influence of trade unions and the extent and sophistication of competition."
>
> "Rates of return on investment in the mining industry fluctuate markedly with metal prices. Hence the distribution of assets and profits in percentage terms will vary depending on relative prices at any point in the business cycle. Movements in exchange rates since initial investments were made have often altered returns, expressed in a single currency. This problem is compounded where assets have been revalued in line with domestic rather than international replacement costs."

9. Main influences on FDI decisions

Listed below are possible influences on foreign direct investment. Please rank the six *most important to your company's* new *foreign direct investment in industrial countries and in less developed countries, in both 1970 and in 1983, by writing the number "1" for the most important factor, "2" for the second most important factor, and so on.*

	Reasons for investment in:			
	Industrial Countries		**Less Developed Countries**	
per cent of respondents mentioning a factor in their "top three"	1970	1983	1970	1983
Access to host country's domestic market	*89*	*67*	*82*	*87*
Access to markets in host country's region	*41*	*37*	*29*	*34*
Avoidance of existing or anticipated tariff barriers	*24*	*16*	*51*	*43*
Avoidance of existing or anticipated nontariff trade barriers	*13*	*18*	*29*	*28*
Integration with your company's existing investment	*26*	*37*	*4*	*17*
Changes in your industry's structure	*20*	*22*	*11*	*9*
Slower growth of home market	*17*	*18*	*11*	*11*
Access to raw materials	*13*	*10*	*13*	*11*
Inducements offered by host country	*11*	*12*	*16*	*13*
Integration with other companies' investment	*4*	*8*	*4*	*4*
Comparative labor cost advantages	*4*	*6*	*11*	*13*
Comparative material cost advantages	*4*	*6*	*2*	*4*

	Industrial Countries		**Less Developed Countries**	
	1970	1983	1970	1983
Shifts of political and social stability	*2*	*8*	*9*	*8*
Tax advantages	*6*	*4*	*7*	*0*
Market presence	*6*	*5*	*3*	*0*
Distribution of risk	*0*	*5*	*0*	*3*
Return on investment in R&D	*3*	*3*	*3*	*3*
Development of local market	*3*	*3*	*3*	*0*
Aquisition opportunities	*3*	*3*	*0*	*0*
Exchange rate movements on *siting* (not financing) investment	*0*	*2*	*0*	*0*

Throughout, the dominant motive for foreign investment is seen as the need to gain access to the host country's domestic market and, the second most important influence was access to the regional market (in the case of investment in developed countries and avoidance of tariff barriers for investment in LDCs.) However, some companies commented that their investments in some markets had reached maturity. In the case of LDCs, higher risk and lower-than-expected growth rates were beginning to offset the desire to gain access to new markets. (Generally, we had the impression that in most companies, but *by no means all*, investment was increasingly of a "consolidation", or even "defensive" variety).

Important secondary influences derive from the desire to avoid or preempt tariff barriers (especially by US corporations in 1970, referring possibly to investment in the European Community ahead of its enlargement in 1973). Avoiding nontariff barriers to trade had become a more important motive by 1983 than earlier.

The Americans in particular placed more weight on "integration with company's existing investment" as an influence in 1983 than in 1970. This was regarded partly as a natural stage in the development of FDI— in the 1970s, many companies had only recently begun to invest on a large scale overseas, often initially in marketing and distribution facilities, whereas by 1983 most of the corporations had widespread mature investments in many countries, and complementarity of investment and the effects on their worldwide competitive position was clearly more important. But partly this too reflects the trend towards "consolidation".

European companies placed more weight in 1983 than in 1970 on "changes in the industry's structure" and "slower growth of the home market"—reflections perhaps of the greater impact of the two oil shocks in Europe than the USA and of the spread of gloomier views about the longer-term future for European economies.

"Tax advantages" and "inducements offered by the host country" were regarded as unimportant influences on investment decisions, though some companies stressed that specific inducements could, on occasion, tip the balance of a decision in favor of investment in a particular country if all other conditions were satisfactory—which was, however, rare.

Contrary to widespread popular impression, most companies are very little influenced by access to "cheap labor" or "cheap raw materials". Comparative labor cost or material cost advantages were not mentioned by high technology industries, chemical companies, food and drink companies, electrical companies or pharmaceutical companies. They were not a consideration even for those companies making labor-intensive, low value-added bulk products for the retail trade (such as soap, detergents, surgical dressings etc.). Often these companies had production facilities in dozens of countries. But the dominant consideration, again, was whether the local market could support an economical level of production. The idea of using LDCs as exporting bases was not attractive to most companies.

The only exceptions to this general rule were some companies in the motor vehicle and allied industries.

10. The changing climate for FDI

(a) *In which* geographical areas *has the climate for foreign direct investment either improved or deteriorated in the past five to ten years? Please list the areas below, along with your views, as to the main reasons for the improvement or deterioration.*

Areas in which the climate has improved	**Reasons cited**
Far East/Japan	*government liberalization of rules and regulations of FDI*

	stable and fast growing markets *growing market for financial services* *increased product competitiveness*
South East Asia	*improved investment climate/open door policies by area governments* *improved economic and industrial infrastructure* *more sophisticated politicians, officials and financial community*
European NICs Spain	*prospect or actuality of EEC membership* *government liberalization of investment rules*
Oil Exporting Countries Saudi Arabia	*government investment incentives* *improving infrastructure* *increased purchasing power since oil price increases*
United States	*relaxing government attitudes toward anti-trust enforcement* *relative deterioration in the rest of the world* *renewed strength of oil & gas exploration* *improved social climate-resurgence of work ethic* *liberalization of banking regulations*

Areas in which climate has deteriorated	**Reasons cited**
Europe	*market saturation* *effect of global recession* *increasing labor costs* *EEC regulations limiting management decisions* *non-tariff trade barriers* *erosion of EEC cooperation* *decreasing flexibility in decision making due to government regulations*

Latin/South America	*increased government controls* *arbitrary government intervention nationalism*
Canada	*failure to distinguish between ownership & control* *canadianization (by a Canadian firm)*
Africa	*deterioration of economic and political stability* *"unsafe"*
Nigeria	*increased local shareholdings*

In general, there was far more complaint about deterioration, than satisfaction with improvement. Seventy five per cent of the companies responding to this question complained about Latin and South America, with the majority of those being American companies. Almost fifty percent of the companies (nearly seventy-five percent of Americans) said that conditions in Europe have deteriorated.

The Far East received by far the most positive "votes", followed closely by the United States, with seventy percent and forty percent respectively, with the Americans being more positive than the Europeans about the Far East. Australia received about as many positive as negative votes.

(b) *Similarly, in which* industries *has the climate for foreign direct investment either improved or deteriorated in the past five to ten years? Please list the industries below, along with your views, as to the main reasons for the improvement or deterioration.*

Industries in which climate has improved	**Reasons Cited**
Electronics, computers, telecommunications, defense	*increased public and private demand cost curve dynamics, technological development, social changes*

Energy & resource exploration	*search for lower cost sources*
Financial & other professional services	*general worldwide trend away from industry towards the service sector* *liberalized banking environment* *internationalization of travel*
High quality consumer goods	*increasing disposable incomes world-wide*
Export manufacture	*less developed countries' growing need for foreign exchange*
Heavy electrical equipment (in LDCs only)	*drive towards modernization of energy capacity*
Automotive industry (LCDs and Euro-NICs)	*government encouragement of auto investment*

Industries in which climate has deteriorated	**Reasons Cited**
Heavy industry (replies referred to steel, electrical equipment, petro-chemicals, shipbuilding, automobile manufacture):	*overcapacity, protectionism, government supported competition, competition from NICs and LDCs, high energy consumption; Japanese inroads in steel and auto manufacture; performance requirements*
Retail trades	*government regulations and control*
Pharmaceuticals	*protectionism, adverse advertising campaign*

11. Political risk

Does your company systematically monitor political risk and the possibilities of economic policy changes in countries where it has or is contemplating foreign direct investments?

86% YES 14% NO

Political risk assessment provides both a short term and a long term potential benefit. In the short term, it provides at best an early warning system for troubled areas. In the long term, most corporations view political risk assessment as an integral part of their long range planning and strategies.

Those companies answering "no" to this question usually undertook risk analysis prior to a particular investment decision.

12. Hedging strategies

What are the main ways in which your company protects itself against political risk and possibilities of economic policy changes?

Many corporations laid the main emphasis on structuring their global strategy to reduce risk; others talked more about their efforts to maintain good relations with host governments and the local community.

Many keep their enterprises spread globally to diversify risks, as a seemingly separate strategy from merely seeking markets. Some avoid investments in regions outside the developed market economies. Others, mainly producers of consumer goods, maintain a low profile in foreign countries, and avoid contact with the government on anything but a commercial level. Several mentioned that they minimize equity exposure and require their subsidiaries to finance themselves, either with local debt instruments and/or equity financing. Some have disinvested in risky areas. Quite a few mentioned using political risk insurance available through government agencies (like the Overseas Private Investment Corporation) to cover themselves. Most use senior management of subsidiaries to provide information on the local economy and political trends.

Many employ nationals as managers. Several mentioned they maintain active public relations programs with the governments and that they try to be good "citizens" or "part of the local economy". Others emphasized that they try to pursue investments which are seen by the government and nationals as beneficial to the country. Joint ventures were seen as providing on way to "involve local support" and sharing risks.

Two perform "regular security surveys of local business entities and senior management residences".

13. The influence of exchange rates

What, in your view, have been the main effects of wide fluctuations of exchange rates *on the volume, direction and nature of foreign direct investment flows?*

Many answered that while exchange rate fluctuations are considered when various projects are analyzed, they are only one of many factors which are evaluated and by themselves often have little impact.

Most respondents maintained that the main effect of foreign exchange movements is not on the direction or level of FDI, but rather on its financing.

Some however, said that the uncertainty created by wide movements caused reluctance to contemplate large projects in countries affected by such swings.

One corporation pointed out that short term swings are relatively unimportant in influencing flows, but that long term trends which are out of line with economic fundamentals affect future decisions about investments in particular countries. Another company commented that while in its opinion currency swings had not affected FDI per se, they had affected flows primarily of a portfolio nature in several instances. Fluctuations were also said to have some effect on the timing of investment projects, with one company saying that it had delayed and cancelled some projects because of currency problems.

14. The influence of interest rates

Similarly, what have been the main effects of wide fluctuations of interest rates *on the volume, direction and nature of foreign direct investment flows?*

Again, most corporations said that the fluctuations in rates had had little impact on the direction or volume of their investment flows. More companies expressed worries over the effect of high real rates, not the fluctuations of nominal rates of interest. Some indicated that they were more selective in making investments, and that fluctuating rates had induced them to invest in the "safer" MIC economies. A few respondents, notably banks, suggested that over the longer term, fluctuations would have a negative impact on FDI.

One company, echoed by four or five others, said that wide interest rate movements (and high real rates) had had a significant impact on the level and direction of FDI. Their comments:

> "Interest rate volatility has had a significant impact on investment flows. The high interest rates in the developed economies have led to reductions in investment volume, and correspondingly the direction and nature of investments are being altered."

> "Because new direct investments are normally highly leveraged (for many reasons, such as: dividend limitations, tax considerations and availability of debt), the increased interest costs associated with high interest rates have raised the threshold for new investments becoming feasible. Moreover as worldwide growth has declined and political/

economic risks have increased, the impact of added interest expense reduces the risk adjusted potential for new enterprises in many areas and industries (e.g., Latin America and Africa's primary industries)."

"The one possible exception would be the electronics industries in the newly developed countries of the Far East (e.g. Taiwan, Singapore and South Korea). In this area more stable political climates exist, associated with policies to reduce return volatility of new investment projects (e.g., South Korea's legislated reduction of interest rates)."

15. From study to execution

Approximately what percentage of foreign direct investments seriously studied by your company are actually made?

58% (mean)
90% (maximum)
10% (minimum)

Corporations in capital-intensive industries like chemicals and heavy electrical equipment tend to make a high proportion of investments studied. Those with low ratios tend to be in food processing, service industries, or in mining.

During the last five to ten years, 26% reported that the proportion of investments studied and then actually made had decreased, 15% that it had increased:

Increased:	15%
Decreased:	26%
Remained about the same:	59%

Of those corporations reporting a decrease in the number of projects actually executed most ascribed the decrease to uncertainty over future business opportunities. Others commented that they were investigating larger projects than they had in the past, of which fewer were implemented. A few companies said they had found no suitable new investments. One corporation indicated that it had almost fulfilled its global corporate strategy and was therefore slowing down the rate of new investments. Joint ventures were also mentioned as a reason for the decline in the number of projects actually executed.

16. Target payback periods

Please indicate, where applicable, your company's target payback period (in years) for new foreign direct investment in industrial countries and in less developed countries both in 1970 and in 1983.

Industries compared

years

	Industrial Countries		Less Developed Countries	
	1970	1983	1970	1983
Mining	7.0	6.0	6.0	5.0
Manufacturing	4.5	4.5	4.4	4.5
Trading	4.3	3.0	2.5	2.0
Finance	5.0	4.8	4.0	4.2
OVERALL	5.3	4.7	4.2	3.9

Several were sceptical of the value of such "targets" or the more popular "rate of return" concept and did not respond. Some suggested that a "post mortem" analysis would reveal a very different story.

A higher proportion of US firms responded to this question. The answers for manufacturing are nearly constant. In all other industries, the typical response calls for a shorter payback period for LDCs compared to ICs and for 1983 compared to 1970, indicating possibly a shift in the distribution of investment to areas promising a quick return.

US companies consistently looked for a much shorter payback than Europeans (there is no indication whether they achieved it or not).

US	*4.5*	*4.0*	*4.0*	*3.5*
Europe	*5.4*	*5.5*	*5.0*	*5.6*

The main reasons given for the shorter payback period looked for now than in 1970 were: the increased cost of capital, greater political and financial risks, and the need for earnings (poor financial position of the parent company).

17. Plant versus R&D

During the last five to ten years, has there been a change in the ratio between investment in plant versus investment in the application of management and technology within the total of your company's direct foreign investment? Please answer below for both industrial countries and less developed countries.

	Industrial Countries	**Less Developed Countries**
	per cent	
Proportion of investment in plant has increased	*19*	*18*
Proportion of investment in application of management and technology has increased	*39*	*26*
No major changes in proportions	*42*	*56*

In recent years increasing emphasis has been placed on R&D, and this, together with increased demand for local manufacturing and development activities, has led to an increase in the proportion of investment devoted to the application of management and technology. However, most companies consider the two activites as complementary, and report no major change in the proportions.

To quote from a number of replies:

> "The increase in investments related to the application of management and technology is a natural result of the renewed focus of the group on research and development."
>
> "Both industrial and less developed countries have increased their demand for local manufacturing and development activities. For the most part, meeting these demands has required a transfer of technology because investment in plant had been made previously."
>
> "There has been a tendency throughout the world for the traditional straight equity sale to give way to more complex arrangements. Investors are rewarded partly through management contracts of various types rather than a straight share of the profits. More is written about a few atypical contracts, however, than about most investments which have followed traditional forms" (a mining company).

18. Forms of investment

What changes in emphasis have there been, or do you anticipate, away from some forms of foreign direct investment and toward others? Please write "more," or "less" or "none" for each type of investment for both industrial countries (ICs) and less developed countries (LDCs) for each five-year period shown below.

Forms of investment

per cent of all respondents

		Sole investment in new ventures ("green fields")	Full acquisition of businesses abroad	Portfolio control of businesses abroad	Joint ventures
			1973-77		
ICs	More	35	38	14	29
	Less	7	5	10	7
LDCs	More	26	14	12	38
	Less	17	10	7	7
			1978-83		
ICs	More	33	43	23	39
	Less	18	9	9	14
LDCs	More	30	16	14	36
	Less	21	16	9	11
			1983-87		
ICs	More	27	38	25	43
	Less	32	23	8	18
LDCs	More	30	10	15	46
	Less	28	8	5	7

Within the move away from green field investments towards joint ventures and acquisitions, American companies expect to rely heavily on joint ventures both in LDCs and in industrial countries; Europeans expect to rely on full acquisition of businesses abroad in industrial countries (mainly in the United States) and joint ventures in LDCs; while Japanese companies still appear to place emphasis on sole investments in new ventures.

19. Which way for FDI finance?

What changes have there been, or do you anticipate, in methods of financing new or expanded foreign direct investment? Please write "more", "less" or "none" for each method listed for each five-year period shown below. (All respondents)

	1973-77		**1978-82**		**1983-87**	
	More	Less	More	Less	More	Less
Retained earnings of parent company	43	21	26	40	28	42
Retained earnings of foreign subsidiaries	49	7	52	12	67	7
Issue of new equity in parent company	12	5	17	7	19	14
Issue of new equity in host country	12	7	21	5	45	5
Debt issues in parent country	29	2	38	12	29	24
Debt issues in host country	39	12	55	10	57	12
Debt issues in world markets	32	12	50	5	55	2

Generally, the companies hope to rely much less on retained earnings of parent companies as a source of FDI financing, doubtless reflecting pressures on parent company earnings and balance sheets. Instead, they hope to use retained earnings of foreign subsidiaries, debt issues in world markets and host countries, and equity issues in the host countries.

Most US companies expect to rely more on debt issues in world markets, whereas European and Asian companies expect to rely more on issuing new equity in host countries, presumably issues to finance acquisitions in the United States. All however, expect foreign subsidiaries increasingly to finance their own expansion internally, though whether such expectations will be realized is another question.

Publications

Policy Statements:

Measures to Combat Inflation
The Group of Thirty

The Problem of Exchange Rates
The Group of Thirty

The World Economy Between Recession and Recovery
H. Johannes Witteveen

Study Group Reports:

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The Reserve Assets Study Group

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The Exchange Markets Participants' Study Group

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The Capital Movements and the Growth of International Indebtedness Study Group

The Outlook for International Bank Lending
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Address inquiries to:

The Group of Thirty
725 Park Avenue
New York, New York 10021

About the authors:

Marjorie Deane is Editor of The Economist Financial Report

Robert Pringle was Editor of The Banker *from 1972 to 1979 and since then has been Executive Director of the Group of Thirty.*

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Group of Thirty

Economic cooperation from the inside

by

Marjorie Deane and Robert Pringle

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Economic cooperation from the inside

A report by Marjorie Deane and Robert Pringle, based on interviews with:

From France

Raymond Barre, former Prime Minister
Jean-Yves Haberer, former Director, the Treasury
Claude Pierre-Brossolette, former Director, the Treasury
Jacques Wahl, former Secretary General, the Office of the President of the Republic

From Germany

Otmar Emminger, former President, the Bundesbank
Leonhard Gleske, member of the Board, the Bundesbank
Bernhard Molitor, Assistant Secretary for Economic Policy, the Ministry of Economics
Helmut Schmidt, former Chancellor, the Federal Republic
Horst Schulmann, former Secretary of State, the Finance Ministry

From Italy

Tommaso Padoa-Schioppa, Special Adviser, Bank of Italy, former Director General for Economic and Financial Affairs, the Commission of the European Communities

From Japan

Michiya Matsukawa, former Special Adviser to the Minister of Finance of Japan, former Chairman of Working Party 3 of the OECD

From the Netherlands

Johannes Witteveen, former Managing Director, the International Monetary Fund

From the United Kingdom

James Callaghan, former Prime Minister

Sir Kenneth Couzens, former Second Permanent Secretary, Overseas Finance, H.M. Treasury

Denis Healey, former Chancellor of the Exchequer

C. W. ("Kit") McMahon, Deputy Governor, the Bank of England

Sir Peter Middleton, Permanent Secretary, H.M. Treasury

Lord O'Brien, former Governor, the Bank of England

From the United States

Richard Erb, Executive Director, the International Monetary Fund

Robert D. Hormats, former Assistant Secretary for Economic and Business Affairs, the State Department

Henry Owen, former Personal Representative of the President of the United States, Ambassador

Anthony M. Solomon, President, the Federal Reserve Bank of New York

Paul A. Volcker, Chairman, Board of Governors, the Federal Reserve System

Edwin Yeo, former Under Secretary for Monetary and Economic Affairs, the Treasury

From International Institutions

William Dale, Deputy Managing Director, the International Monetary Fund

Alexandre Lamfalussy, Assistant General Manager, Economic Adviser, the Bank for International Settlements

Stephen Marris, former Economic Adviser to the Secretary General, the Organization for Economic Cooperation and Development

Francois-Xavier Ortoli, former President of the Commission of the European Communities

Emile van Lennep, Secretary General, the Organization for Economic Cooperation and Development

Alan Whittome, Director, European Department, the International Monetary Fund

N.B. Several of the above now hold other positions in the private or public sector, which are not shown.

Economic cooperation from the inside

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Economic cooperation from the inside

Introduction

This study evolved from worries expressed last year by members of the Group of Thirty about the state of international cooperation on general economic and monetary issues. Political, nationalistic and personality overtones make this a complicated and nonrewarding subject for open debate. So we asked leading figures in current and recent past negotiations to talk to us one by one on a confidential basis, the understanding being that their views would not be identifiable in the subsequent report. While recording our appreciation of the time they have given to this study, we feel their willingness to do so reflects their concern and encourages us to believe the project has an important message.

On the other hand, we should not give the impression our survey is exhaustive. We have not attempted to cover all types of international negotiations that involve economic issues. Though trade and energy issues are necessarily referred to, we did not interview negotiators in such specialized areas. And we have concentrated on American and European views since these have mostly polarized the debates at a macroeconomic level.

A standard set of questions was used as the framework for each interview. We report in the next section what we believe is a fair representation of the answers to these questions. But the interviews ranged more widely, as they were intended to do, so that our conclusions are by no means drawn exclusively from the questionnaire responses.

Many readers will dispute some interpretations of past events, and some perceptions of current developments, reported here. Many of the episodes referred to remain controversial. The purpose of the exercise is not to rewrite history or to pretend to come to a "true" view of the present state of cooperation, but to report as fairly as possible what we have been told. The usefulness of such reporting rests on the assumption that the perceptions of people actively engaged in international negotiations today may have a force of their own; and that it is better to be aware of these perceptions, especially if they are not in accordance with one's own views, than to take refuge in abstractions or hazy expressions of "international goodwill."

Closing of ranks

From the outset it was clear the timing of our interviews, most of which were carried out between January and September, 1983, was particularly sensitive. Had we made our investigation a year earlier, our panelists would almost certainly have been even gloomier about cooperation than they were and probably there would have been no doubt that it had deteriorated over time. But the closing of ranks in the face of the threat to the entire financial system from the debt problems of Mexico and other Latin American countries has here and there struck a new note of optimism, particularly among those now holding positions of responsibility — indeed, to some it reflects a strength in cooperation beyond that ever seen in the past.

Paul Volcker referred to this in a speech on April 28, 1983:

> "I was asked recently, as part of a survey of monetary officials, whether I sensed that international economic cooperation had in fact declined over the past 10 or 15 years. What people mean by cooperation is highly subjective, and I doubt my answer was enlightening to the inquirers. But the question intrigues me, and I have tried it out on my colleagues at home and abroad. What surprised me — and may console you — is that in my informal survey a number of officials actually on the firing line throughout this past decade, in the United States and Europe, responded quite positively. In the face of severe challenge from technological change, from economic and political "shocks," and from the sense of more difficult and complicated domestic problems, they were inclined to see *more* willingness to consult in a meaningful way. They felt we are now more open and candid with each other, that we exchange more information — and collect more of it together — and that we are at least as willing as before to recognize joint problems and consider joint solutions. Implicit or explicit in that view was the idea that mutual recognition of the desirability, where possible, of looking to 'market' solutions can itself be a constructive act of cooperation."

This optimism needs to be qualified. First, there is the obvious point that the debt problems of the developing countries have by no means been solved by the rescue packages, any of which could come unstuck at any moment. Cooperation was being tested, rather than proved, as we did our interviews. Second, it is open to question whether these rescue operations, even if they are successful in their immediate purpose, will seem as good in retrospect. Might they not, like some similar operations 10 - 20 years ago, be only postponing the inevitable and increasing the eventual cost?

Only time will tell. Depressingly, however, postwar economic history relates that it has required a perception of crisis, a pragmatic judgment that quick action is needed, to obtain a major cooperative response. Even the

Bretton Woods agreement on fixed-but-adjustable exchange rates is perceived as having required wartime stimulus. As their examples of successful cooperation after Bretton Woods, several of those interviewed chose the central bankers' support operations for serling in the mid-1960s, yet added ruefully that, looking back, it would probably have been better if sterling had been devalued sooner rather than later. By their very nature, rescues indicate that a dangerous situation has been allowed to develop and sometimes the damage has already gone too far.

The art of the possible

The cautionary tale told, we still see the coming-together over the debt problem as a foundation for something promising. And we think our investigation indicates that it might be best to build on what looks possible and what impossible.

Some of the factors that are perceived to have been working against international cooperation may be only temporary, some are more permanent. In the first category comes the doctrinal policy of some of today's big powers that demands minimal government interference and full play for the markets. However, this attitude has already been softened by experience and, anyway, governments change. Perhaps in the same category, though less clearly so, is the confused state of economic theory — the economics profession got bad marks in our interviews. The lack of understanding of key issues — such as the relationship between massive budget deficits and interest rates — makes it hard to develop any political consensus.

A permanent change with important implications is the decline in the weight of the American economy in the system — a continuing refrain in the comments made to us, especially by Europeans and Japanese, but also by some Americans. As one put it:

> "The decline of the United States from being 'hors de concours' to being 'primus inter pares' is itself destabilizing. An oligopoly is inherently harder to handle than a monopoly, if the monopolist is benign"...

The comment, of course, is not implying cooperation has declined, but rather that it is never called for if one power has dominant control of the system. The reason everyone backs away from any thought of re-writing Bretton Woods is not that three or four times as many countries would be involved today, but because the 1944 so-called "agreement" was, in fact, an American-written rulebook for running a dollar system, even if a lot of British ideas had gone into it — and even then it needed to be helped by wartime urgency.

The amount of cooperation actually called for in adhering to the

Bretton Woods rulebook can also lead to a semantic discussion. Although perhaps the most fundamental issue raised, in different ways, throughout the interviews is whether any significant improvement in international monetary and economic cooperation can be expected in the absence of a return to a framework for greater exchange stability, this probably reflects the widespread disenchantment with the system of floating exchange rates rather than a judgment on cooperation. Floating has not removed the need for cooperation, as some of its advocates had claimed. Yet in the view of most of our respondents it has made cooperation more difficult. Under fixed rates, there are sanctions for not obeying the rules — you get flung out of the club. There are no such sanctions in a floating world and what are the rules anyway?

As a former European prime minister said, under the previous system, "there was a code of good conduct." This has not been developed under floating. The attempt in the mid-1970s to establish "guidelines" for floating was widely regarded as premature. Under floating, some exchange rates have been out of line with underlying competitive positions for much longer periods than had been expected. This instability has tended to ratchet-up the level of protectionism and of inflationary pressures (or of unemployment, if inflationary pressures are offset by tighter monetary policies) in the global economy.

The mechanism by which an international view on a country's policies (and on the consistency of the policies of the major countries) is developed, is widely perceived to be less effective than it was under Bretton Woods. As the major governments do not either need to go to the IMF for approval of a parity change or to obtain parliamentary approval at home for it, the possibility for other countries or international organizations to influence national policies has obviously been much reduced. As a practical matter, it is much harder to make governments aware of the international dimension to policy in the absence of discrete parity changes.

Gradual evolution

Very few contemplate wide-ranging reform of either the exchange rate system or the functions of the multinational institutions. Memories of failed or misplaced attempts going back to the 1960s inhibit any ambition to try again.

Wrangles over the launch of the IMF's SDR that took up the time and energy of the officials in the 1960s at the cost of more pressing demands, the theoretical debate of the Committee of Twenty that got nowhere in the early 1970s, the sudden demise of the IMF's hard-fought plan for a substitution account: enough is enough. And while the institutions do not escape criticism, again realism dictates that only minor modifications and gradual evolution are feasible.

Most of our respondents rate the IMF the most important of the international institutions and strongly favor a boost in its resources. Of course, they had the rescue packages for Mexico, Brazil and other major debtors in mind and might not have been as enthusiastic before August, 1982. Even so, there is a body of opinion that regrets the IMF's shift, as it is seen, towards an aid institution and feels it has sloughed off too easily responsibility for monitoring the new exchange rate system, which would necessitate having more influence on the big powers' economic policies. But again the realists are in the majority. "International institutions," as one said, "provide a useful talking shop, but they can only really influence our policies if they have money to lend and we need it."

So reform — if that is the right word — is not going to come by way of the institutions, according to our panel. It will be a political process which the officials can help along but not cook up solely among themselves. Our panel takes a somewhat cynical view of summits of heads of state, but nevertheless sees them as the most promising forum for setting new trends.

A new beginning?

Our study has detected a growing sign of willingness in the past few months to give external factors a higher priority. In particular, the Reagan Administration is taking a more accommodating stance. Criticisms made quite frequently by our respondents were to the effect that "the international monetary system changes every time there is a new Under Secretary for Monetary Affairs at the American Treasury" and "each new Administration tends to sell policies that have been formulated to meet domestic political and ideological interests to the rest of the world." The present Administration is seen to have been particularly culpable, but several people commented on the inexperience of officials brought in to most Administrations — "it's a two-year learning process."

So the shock of the LDC debt crisis has coincided with — or brought about — a more helpful American attitude internationally, at the same time as the last lingering illusions that floating rates would remove the need for explicit cooperation have evaporated. We identify two areas where, with a little push, international cooperation may now be strengthened.

The first — the international regulation of banking and financial markets — may seem a little mundane, but could have far-reaching consequences. A consensus reached by the Basle committee on bank regulation — recently revised — has never been put fully into practice. For instance, even the agreement to require consolidated accounts from banks has not yet reached legal status in West Germany. Now at least some new ideas are afoot, which could conceivably bring in the IMF, as well as the BIS.

More fundamental would be some conscious rule-making for the system, which, said a key policyholder, "I would not rule out." What might that involve? It would, presumably, entail some rules about intervention in the markets by the big three or four countries (principally the United States, West Germany and Japan) — perhaps target zones of the "wrong" rates rather than the "right" ones. At least one European would like to see the ECU involved — "fixed-but-adjustable parities between the ECU, dollar and yen." More crucially, it would involve some voluntary coordination of monetary policies — a big step forward in a world where, up to now, coordination has occurred only under duress.

Economic cooperation from the inside

Answers to questions

1. Do you think that international economic and monetary cooperation between major countries has deteriorated and if so how is this evident?

A majority said that international cooperation had deteriorated in recent years. "It is now much more defensive," a former US official said; "there is less consensus on monetary policy, major differences in domestic policies and unrealistic exchange rates". As one European put it:

> "All the things that link countries together — trade, exchange rates, interest rates, payments balances — have shown much greater volatility and are under growing pressure. The fall-off in the rate of economic growth is partly a consequence of this lack of cooperation".

Some participants contrasted the response to the first oil shock in 1972-73 with that to the second in 1979-80. After the first, there was an attempt to forge an international consensus on recycling and though the response may have been inadequate, steps were taken to enlarge the capacity of the IMF and other international institutions to help countries affected by the steep rise in their oil bills. There was also agreement to try to avoid beggar-my-neighbor trade policies. In contrast after the second oil shock, governments concentrated on fighting inflation and inward-looking policies were more prevalent. Each country went its own way. All the governments that had come to power in recent years were less "internationalist" than their predecessors.

Failure to bring about more coordination of economic policies in forums like the IMF's interim committee or summits was noted too. Europeans grumbled that they had been unable to persuade the United States to modify its policies on budget deficits and interest rates. "Cooperation is as bad as it has been at any time in the past quarter of a century", said one.

At the outset of this survey some contrasted cooperation among central banks with that among governments. To quote one American observer, who like some others defined his terms carefully:

> "Understanding 'cooperation' to denote a sense of shared objectives and un-

> derstood differences, and the politics as well as the mechanisms involved, central bank cooperation has become better and cooperation among finance ministers substantially worse".

Whether or not central banks coordinated among themselves, one former European prime minister blamed the central bankers for not monitoring the international banking system, and for not warning their governments of the dangers of allowing the debts of developing countries to snowball: "Central bankers should have tried harder to understand what was going on."

Many participants viewed the 1950s and early 1960s as the high watermark of cooperation. As one put it, the Fund managed the fixed-rate system and the OECD provided an effective vehicle for the coordination of macroeconomic policies in a fixed-exchange-rate world. Underlying the relative smoothness of monetary cooperation was the stability of the dollar itself. Conscious cooperation was unnecessary because a cooperative outcome was taken for granted. The need for cooperation was felt only when that framework began to disintegrate.

Opinions differed as to when that disintegration started. Some put it in the mid-1960s, when it became clear that the United States was not willing to allow its policies to be constrained by the operation of the gold-exchange standard, declining either to tighten its monetary policy sufficiently to validate the pattern of fixed rates or to devalue the dollar. Efforts to shore up that earlier system started in the early 1960s with the arrangements to defend the dollar and continued with the struggle to maintain sterling at $2.80 and the search for a new reserve asset from 1965 — evidence of the extent of cooperation or of the growing strains on a doomed system, according to taste.

More conventionally, most dated the decline from August 1971, when President Nixon not only brought the curtain down on Bretton Woods by suspending the convertibility of the dollar into gold but also imposed the temporary import surcharge, introducing a new nationalistic flavor to US international monetary policy. Others pointed out, however, that with the agreement on a new set of parities in December 1971, "we thought we were moving to a managed exchange rate system", and that it was only with the move to generalized floating in March 1973 that the effort to maintain a formal framework of exchange rates ended.

Some, however, said the decline began only in 1981, when the Reagan Administration took office. Many showed extreme frustration with the Reaganite policies in 1981-82 — notably the volatility of US monetary policy, the indifference displayed with regard to its effects on the outside world (and, in the long run, for the United States), plus the bad-mouthing of the IMF and World Bank. "Until January, 1981", said one former US official, "I don't think that cooperation did decline. There was less cooperation on the system, but not less on substance".

Others said it was too easy to blame the Reagan Administration. Under Carter and Nixon too, there had been a strong tendency in the United States to ignore other countries' problems or misinterpret them, and a lack of judgment in public speeches, together with a bewildering turnover of policies, each of which was presented as the solution to all difficulties, adding to the general confusion and unnecessarily aggravating natural differences of perspective, intellectual tradition and national interest.

Not unqualified gloom

A few respondents maintained that although some forms of institutionalized cooperation had suffered, there had been no deterioration in:

(a) "Fire brigade" operations, or specific acts of cooperation, to shore up the system — examples included the dollar support package in November, 1978 and the more recent LDC debt problem. "When action is needed quickly", said a central banker, "you will get major cooperation — probably more than in earlier years".

(b) Cooperation in a limited area of policy, where the benefits to all plainly exceed the costs (as in agreements to reduce energy consumption or on export credits).

Several respondents, including some of those who maintained that cooperation had not declined, remarked that it had never been as close as it may seem in retrospect (e.g. the French devalued in 1957 without any prior warning; Germany upvalued the mark in March 1961 without consulting the IMF or the EC; Germany floated the DM without prior warning in May 1971 and finally the US suspended gold convertibility in August 1971 again without warning). Equally, the outlook was better than might appear. Among the reasons given were the following:

(a) countries' understanding of each others' economies had much improved, partly as a result of the regular analyses conducted over the years by the leading international organizations, and partly because of more intensive discussion in the past ten years of general economic policy as well as exchange rates, especially in the EC;

(b) in spite of everything, trade had continued to grow until 1982, as had the "openness" of the main economies;

(c) there had been agreement on the need to fight inflation, and the better harmonization of inflation rates around a lower level of inflation that has resulted may usher in a new epoch of better price stability. This could provide a good basis for working again towards close cooperation, "with the goal of making monetary policy less volatile and the international monetary system more stable";

(d) the Reagan Administration had received a series of big shocks (after two years of ~~giving shocks to~~ everybody else) and had swung round 180 degrees on the attitudes that had previously given so much offence, notably towards the international organizations. "Americans have shown a capacity to become more pragmatic when the problems burn their own fingers".

2. If you agree that cooperation has deteriorated, do you think this is because:

(a) the problems to be solved have changed in nature; or

(b) the machinery for cooperation is less effective than it was; or

(c) governments have more limited control because of political and other constraints; or

(d) there are disagreements as to the appropriate economic policy response?

Nearly all our respondents who think international cooperation has deteriorated said one reason was the confusion today over the appropriate response to growing economic problems and the uncertainty this causes — i.e. (d) in our questionnaire. Many of them think this — plus the general deterioration of economic conditions — the most important reason, though several also believe governments' control over their own economies has lessened, which also weakens cooperation: "You can't coordinate what you don't control", as one central banker put it. Everyone, whatever their views on cooperation, considers problems have changed in nature — which is fairly self-evident. Surprisingly few, however, think the machinery for cooperation is less effective than it was, though the few who do have a clear explanation.

(a) the problems to be solved have changed in nature

There was overwhelming agreement that problems have changed, and a number of areas were highlighted: floating exchange rates, capital movements, energy, inflation, bulging budget deficits and trade policies.

To many but not all central bankers, floating was the most important change and a bad one in the context of this study. Advocates of floating had said it removes the need for cooperation, but clearly that is wrong and strong interdependence remains. "Floating rates work against cooperation and over time encourage nationalism", said a European central banker. The other big financial change mentioned by several respondents was the growth of the Eurocurrency market in the past 10 years. "We have not yet sufficiently grasped the effects of this growth or of floating exchange rates," said one official.

To some, however, monetary problems such as exchange rate swings are not the fundamental worry: "their role is exaggerated by the politicians who are always looking for scapegoats". Trading problems are dominating because economies are much more open. So there is a new sensitivity to competitive pressures, both at the level of the firm and whole sectors. Because of competition from the NICs (newly-industrializing countries), structural changes are needed in European industries, but the response has been more and more EC intervention, which creates permanent contravention of market rules. "Politicians should take the lead in explaining the need for changes. They haven't even got people used to the competitiveness of Japan, let alone the NICs".

To others the main bugbear is still inflation. As one official put it:

> "Inflation at the rate we've been seeing has not been a common feature of the world — it is a relatively recent phenomenon."

(b) the machinery for cooperation is less effective than it was

Most said the machinery is in place and potentially no less effective than it was. One view was that the machinery (or the mechanism) was "incomparably better" today, as compared with the period before 1973.

Some said that the management of one or another of the major international institutions could have been more effective (see answers to Question 6); and a minority implied that the machinery itself was less effective. A central banker observed:

> "A lot of machinery disappeared with the breakdown of Bretton Woods; it had sanctions, notably going to the IMF for support. True, a good deal survives but with floating rates it is not the same".

The machinery was also seen as having failed to adapt adequately to changing circumstances, particularly to balance-of-payment imbalances after the two oil shocks.

> "So long as bank recycling worked, nobody considered it necessary to restore the institutional framework — the only progress made was in the EC. But now this is changing and the climate again becoming conducive to international cooperation".

The reference was to the recent agreement to provide the IMF with more resources. This had come about, explained a European official, not only because of the many problems in commercial banking, but also because the United States was having second thoughts.

> "It could not get its budget-mix right, so used monetary policy, which pushed up interest rates and overvalued the dollar. It now wants to get the dollar down but needs cooperation from other countries to achieve that. It's the old story of a reserve currency country being unable to devalue if others lower interest rates and so on".

Some international civil servants expressed their concern that the machinery has moved away from meetings of officials to meetings of ministers and of heads of state. It was logical and perhaps unavoidable, but, in their view, made for less effectiveness because these meetings are not backed up with adequate staff work nor is there a proper follow-through.

(c) governments have more limited control because of political and other constraints

Several of our respondents did not consider governments have more limited control than they had. "Don't think they ever had all that much, given the fact we live in a trading world", was a typical comment. But they were in a minority. Others thought it obvious that governments have less control than they did in the 1960s because of the oil price increase, huge capital movements, (e.g. the flood to America as a result of high interest rates since 1980), operations of multilateral corporations and international bank lending. One finance ministry official thought the question was a bit skewed: as he saw it, the environment in which governments have to operate has left them with less stability in which to do whatever they were doing about their own economies. Others mentioned the increasing complexity of managing public-sector deficits and government spending. "It is quite a different world, struggling with giant public-sector deficits", said one official.

(d) disagreements as to the appropriate economic policy response

As we have already reported, this was seen as the most important of the causes listed, though it seemed to be contradicted by the view, also taken by many, that the big countries have never been as unanimous in their policy aims as in the past few years. Except for France's dash for growth in 1981, all had pursued resolutely anti-inflationary policies for the past four years. How could they disagree when they were all set on similar courses?

Part of the explanation for this apparent paradox is that countries have pursued these anti-inflationary policies by means of very different "mixes" of monetary and fiscal policy, and it is these differences that have accounted for much of the disputes over policy — notably many Europeans' criticism of US budget deficits which in their view have kept US interest rates at such high levels. The refusal of the US administration to modify these policies, or even apparently to listen to European criticism, was the most frequently-mentioned specific irritant in recent international monetary discussion.

Another part of the explanation is that while major countries have made the control of inflation their top priority, this by no means reflects a consensus of view within each country, least of all among economists. On the contrary, both political and economic opinions were seen as increasingly polarized. At any moment, therefore, the chances are that before long a number of governments will come to power with completely different notions from their predecessors of what should be done internally — and by extension, internationally. As a former senior international civil servant commented:

> "Such disputes and the accompanying uncertainty can only add to the general confusion and scepticism about the feasibility of international cooperation: there is always a tendency in such situations to fall back on simplistic solutions".

Yet another reason for the apparent contradiction is that, as one former European minister emphasized, while countries' policies may be set on similar courses, this does not necessarily imply any convergence in the underlying structures of their economies or in their relative tolerance of unemployment or inflation. Tight monetary policies have put a lid on inflation, but the domestic conflicts that generated pressures for accommodating policies remain — and their strength differs greatly among the leading countries.

Probably most participants would agree with the American who said that "people are very confused and want to go in different directions. If there is no consensus about what you want to do in the international area, people don't want ever to undertake a major negotiation. They shy away from it, and then by definition domestic considerations take priority".

3. Has the conflict increased between internal and external objectives? If so, why do you think this is?

A majority of our respondents thought the conflict had increased. Most of those who did not, felt it was impossible to generalize; the situation varied from country to country. Only one suggested that the conflict has decreased. Several emphasized that the generalized floating of exchange rates had not eliminated the conflict, as some of its advocates had predicted in their initial enthusiasm for it.

Why had the conflict increased? Here are some of the replies:

(a) Internal objectives are clearly much more important at times of massive unemployment. But an expansionary policy may be in conflict with the need for external balance.

(b) The conflict has increased — or has appeared to — largely because of monetarism. "The more countries look inwards, with policies directed to internal objectives, the less they care about external factors", said a central bank official.

(c) Another conflict resulted recently from US high interest rates during a period of stagnation. In several countries, such as Germany and Britain, interest rate policy has had to be oriented to the dollar exchange rate, in conflict with domestic requirements.

(d) "Without the discipline of the Bretton Woods system, external objectives are relegated to second place", was the quick response from a former central banker. Another former central banker, however, said that floating imposed as much discipline as fixed rates.

(e) A somewhat different view from an international civil servant: "Because of growing interdependence, the margin of maneuver for pursuing domestic objectives has been reduced for everybody, including the United States. Events in one part of the world spark repercussions far away; for example, the Polish debt crisis precipitated the Latin American crisis".

France was often cited as a case among the big powers recently in showing the continuing conflict between internal and external objectives in having to try to keep up with the DM within the EMS. For smaller countries too there is more conflict because they perceive it as in their own interest to peg their exchange rates. Others said that even big countries had faced greater conflicts recently, partly because more of them had currencies that were now widely held abroad as reserve currencies.

There were some wry comments from Europeans along these lines:

> "The Americans' problem has always been that they never saw the need to reconcile internal and external objectives. That is exactly how the conflict expressed itself at the end of the 1960s, with the Germans howling their heads off that their internal and external objectives were being brought into conflict by the behavior of the Americans".

A more hopeful note from another participant:

> "Most American administrations start off not believing that there is an external dimension to what they were doing: they all actually came to tend to believe there is. The present one seems to be no exception".

The general view was that internal problems have been acute recently and governments have concentrated on them, but their resolution has been made more difficult by growing interdependence and the influence of intellectual theories saying that all countries need to do is to get their domestic policies right. This means there is a growing temptation to use external instruments to achieve domestic objectives, especially to use competitive devaluations as, for instance, Sweden has done.

4. From your own experience, could you instance (a) a particularly successful piece of international cooperation and (b) a particularly unsuccessful one? Do you draw any general conclusions from your answers?

Respondents interpreted this question in somewhat different ways — some emphasizing the fact of reaching agreement, others judging by results. None of the examples of cooperation given were generally judged successful in terms both of prior intention and results. The SDR — "half success and half failure" — was mentioned as "the only piece of international reform which came about without any pressure of crisis."

Five cited the Bonn summit of 1978, which agreed to put the locomotive theory into practice, as an example of successful cooperation; many cited it as an example of unsuccessful cooperation. To some it seemed enough that an agreement had been reached which had seemed a sensible move at the time, even if, in hindsight, it was not. "The Bonn summit was successful not necessarily in its outcome but it seemed to be a step in the right direction at the time," observed one European official. Another respondent found it very difficult to judge the Bonn summit: "The main objective, as it seemed at the time, was for Germany to do something and such cooperation seemed sensible. What we did not realize was that activity was already picking up in other countries, so we had two or three locomotives. But the outcome was disastrous — not because of the cooperative initiative, but because we misjudged the room there was for stimulation."

The BIS support arrangements for sterling in the 1960s were judged successful by several respondents. But one of them said it should probably be seen also as an example of unsuccessful cooperation since, looking back, it might have been better if sterling had been devalued sooner, "though that would have been a classic example of internal objectives taking precedence." Two chose as successful examples the sterling balance agreements and the follow-up agreements, involving guarantees to sterling holders, backed by a Group of Ten line of credit — "a three-cornered operation," as one of them put it, "involving almost all countries outside Latin America, which let the sterling overhang be run down in a sensible way."

"I could answer EMS to both parts of this question," said one who picked out the EMS — "with all its shortcomings." Some of the more technical achievements, particularly of the IMF, were chosen as successful examples by some respondents and there was no controversy there. Examples included the Jamaica Conference of 1976, which settled the long-standing controversies about the treatment of gold and of floating rates, and produced a corresponding revision of the Fund's Articles; the Witteveen oil facility; and the increase in IMF quotas at the last interim committee meeting.

Others voted for the Basle package for Mexico, and another for "the whole operation which started with Mexico, ran through Toronto and ended in snow in Washington, and included the IMF fix, GAB increase, lashing up Mexico, lashing up Brazil." Two thought the 1974 OECD trade pledge a good piece of cooperation. Two also mentioned the cooperation between the American and German central banks in the autumn of 1978 "during the worst of all dollar crises."

Summits did not come out well. True, two respondents said the Tokyo summit, which concentrated on energy, was an example of good cooperation. But if opinion was split about the Bonn summit, there was no doubt about the Versailles one: that was given the thumbs down by many respondents. The failed attempt at the Puerto Rico summit to set up surveillance for credits to East Europe was one former official's example of unsuccessful cooperation. Another participant dubbed all summit meetings unsuccessful.

The Smithsonian agreement ("which tried to do the impossible"), the Committee of Twenty ("totally unsuccessful," "an enormous sweat that went nowhere") and other efforts to reform the international monetary system were chosen as unsuccessful examples of cooperation by four respondents. Another pointed to the long drawn-out attempt to get the Euromarkets under better control. Two others — both European — cited recent devaluations made without consultation, i.e. the Greek and Swedish ones.

Some drew general conclusions from their answers. "With fixed exchange rates," said a former central banker, "there were rules, civilized ways of altering exchange rates, so the importance of external policy had to be maintained all the time — and that's good housekeeping. With the present system; external policy takes a back seat — and that's bad." Another comment was: "Must have a bunch of strong finance ministers." Three views centered on the need to involve the international institutions or at least strengthen them. "You must build on the international organizations you have got and let them evolve to deal with particular circumstances — keep them with sufficient funds, but not too much money," as one finance ministry official put it.

A former international civil servant said: "The problem of summits is that they keep international institutions out and tend to paper over problems as a result." The view applied to other international meetings also: "If you get ministers of big countries together, there is an overwhelming temptation to overlook real issues and say what others like to hear."

Other participants stressed how much harder it is to get cooperation in general policy than in defined areas. Though one central banker said it was "not impossible to coordinate macroeconomic policies," another was more cautious: "It can't be a one-shot operation, but there are always difficulties with the follow-up and it may not be feasible at all." And an official from a previous US administration was even more gloomy: "It is impossible now to coordinate domestic policies; heads of governments have enough trouble trying to reconcile different interests within their countries."

5. Do you think there is now noticeably less international orientation among (a) central bankers (b) government officials than there was in the days of fixed exchange rates? Has there been less cooperation since floating rates?

Our participants did not think there is less international orientation today among central bankers than there was in the Bretton Woods days, though a few thought this true only recently as a result of the LDC debt crisis. "We need to be all that much closer because there isn't a system," was a comment several others echoed. Another was:

> "Central bankers have withstood better the intellectual challenge to the need for cooperation because: (1) people at the top change more slowly in central banks than in governments and therefore there is more reflection of the older ideas of cooperation; (2) central bankers see the conflict between new ideas and the reality of fluctuating rates more clearly than ministry officials; and (3) their own positions and influence are clearly at stake."

The majority view was that government officials were less internationally oriented than they used to be. Why? One American thought it had nothing to do with floating, which "in the end does the same thing as fixed rates — the discipline of the markets is a discipline on nutty policies and governments." Europeans tended to disagree. One said:

> "The actual degree of integration has outpaced the intellectual capacity to recognize it or understand it, and such understanding is a precondition for the development of a political consensus on what to do about it. We are faced not only with a crisis of economic cooperation and policymaking, but also a crisis of international economic theory."

Was this due to floating? "Yes. In the old days you had to go to parliament and explain why you had devalued, not just say 'It's the markets'."

Another respondent put it this way: "Floating enables governments to escape the need to change policies publicly, so requires no international approval." And yet another: "In recent years, the views of those academics who say you cannot know what the right exchange rate is have had great influence — a theme making it very difficult to discuss anything at all. Yet the yen's rate is crazy."

Other Europeans blamed governments. "It is because of the coincidence of three governments with strong domestic convictions — the Reagan, Thatcher, Mitterrand governments," said one. Five other views were angled specifically on the American government. "The attitude of the United States is all important. If the United States is positive about cooperation, other countries will follow suit. The Reagan administration has been totally negative." But this respondent, like the other four, thought it was not just a Reaganite characteristic. "There has been a tendency before this Administration to ignore other countries and a lack of judgment in public speeches — for instance, Blumenthal on the dollar." Others put it more rudely. 'American administrations are never professional, they're amateurs." However, this was countered by an American view that "the United States is the only country that even thinks about the implications of its actions for the system, or ever takes an internationalist view," and from another: "Serious initiatives which get negotiated seriously do not come from Japan or Britain or France or Germany, partly because of personalities and partly because there isn't sufficient agreement on the substance of the policies." "The Europeans haven't got an idea between them that they can agree on and put collective pressure on us. I must say I am shocked by the Europeans."

6. To what extent does the degree of international cooperation at any given time depend on the personalities of a few key officials?

Nearly all our participants thought personalities were important — many said very important. Former finance ministers or prime ministers were thinking in terms of the top political masters, government officials of the deputy level; some said at both levels. Many said the personalities of central bankers counted for a lot in international forums — Volcker, Richardson, Zijlstra and Leutwiler were among those picked out as notably good. Others stressed the example of political leadership provided by the understanding between Helmut Schmidt and Giscard d'Estaing.

About half those who answered this question mentioned the importance of American figures. As one put it: "It is all very difficult for foreigners if there is no dominant American spokesman." "The quality of US leadership has declined steadily since President Johnson: Reagan has a stronger personality than Carter but understands even less." Several deplored the lack of international orientation of the present Under Secretary for Monetary Affairs at the American Treasury, Mr. Sprinkel.

A few made comments about personalities at the head of the multilateral institutions, making the point that they need to have political weight. "They must have influence in Washington," said a former European finance minister, "or be able to influence enough Europeans to influence the United States." An American observed: "The IMF's Managing Director has to be respected by governments and commercial banks — it's not enough just to give the Fund more money." A former European prime minister put it more strongly: "As the IMF cannot influence the United States, the only substitute is to have great characters to head the institutions."

Against the general trend, a few deplored the cult of personalities; the political environment was more important, they said. These were officials from countries where a strong civil service is traditional.

7. How do you rate the roles that international institutions — IMF, OECD, BIS — have been able to play in international cooperation? How could their contributions be improved?

Comments on this question reflected the widespread view that the political will to use the machinery of cooperation, not the institutions themselves, was the decisive factor. Nevertheless, some respondents said that the institutions could have played a more effective role, within the political boundaries in which they had to function, and two or three respondents were extremely critical indeed. We feel it would be irresponsible to report all the views expressed to us. Nevertheless, in the following summaries we concentrate on the reasonable criticism or qualifications made — taking for granted that all respondents were generally supportive of the international institutions.

The IMF

The Fund was widely held to have had less influence since the advent of floating exchange rates, and never to had had any influence on the United States. Within the limits set by these "facts of life" most respondents said it had been as effective as could have been expected.

Perhaps the most frequent criticism was that in some respects the Fund had "not lived up to what it might have been." Again, this was partly seen as the inevitable result of the political unwillingness to give substance to the provisions of the revised Article IV authorizing the Fund to exercise "firm surveillance" over countries' exchange rate policies. This only made sense if the Fund was allowed to influence policies at their formative state. But at least in the mid-1970s the major countries were not willing to meet regularly with the Managing Director of the Fund. The view was that "We have to see the Fund as a judge" — a view that excluded it from exercising effective influence on the formulation of policies. There was no evidence that the major countries have changed their minds since then.

The Fund's policies were also criticized for their volatility — apparently easing and tightening the policy conditions attached to its lending in an unpredictable way. Once more, this was viewed as perhaps an inevitable consequence of the volatility of US policy. Again, however, several respondents said or implied that the Fund could have tried to withstand these pressures more vigorously. It might have tried harder, some said, to develop an agreed international view of the major problems of the world economy — e.g. in its annual reports:

> "The Fund should always tread close to the margin of what is politically possible," said one.

Several respondents said that the top people in all the international institutions should have political experience and authority, and a feel for the politics as well as the mechanisms involved. When the chips were down, the big issues were settled by a few finance ministers sitting together without advisers, and it was useful if leaders of the international institutions had such political experience.

Some respondents went further. "In the last few years the IMF has rather unimaginatively followed the policies pursued by the major countries."

Others said that the Fund has damaged itself by following unrealistic ideas — as on the Substitution Account ("we all spent a lot of time on it, yet no country ever wanted it — only the Fund staff") and by failing to exercise surveillance. Also:

> "The international situation needs to be explained to the public in plain language, using simple terms. These days one has to try to reach the ordinary educated man. The reports of the IMF are far too theoretical."

A related view was that the Fund had become too much of a development institution, and had not focused enough on the problems of the industrial countries.

> "After all, the Fund is the guardian of the international monetary system and should have lived up to its responsibilities and pressed governments of industrial countries harder. It does first-class staff work but as an institution it does not have much effect on policies."

Article IV was widely regarded as a dead letter, and the attempt in 1974-75 to formulate rules for floating rates premature, though one respondent said that the new article was accurate and relevant. Another retorted that even now, with a growing danger of competitive devaluations, the Fund is not in a position to use its powers under Article IV. But again, at best one could expect only more 'ad hoc,' or 'specific acts of cooperation,' or 'political' cooperation.

It was recognized that the Fund had gained new life in the past few years, and that Mr. de Larosière, the Managing Director, had moved rapidly and courageously to impose the authority of the Fund in gaining the cooperation of commercial banks in the debt crisis. What it had lost in terms of "system management" had been regained in "crisis management."

Comments:

"It takes too much of a one-country-at-a-time view for my taste, but maybe that is inevitable." "The Fund ends up concentrating on things where it is perceived to have a major role."

The OECD

Tributes were paid to the quality of the OECD's economic analysis, and the contribution it had made to better understanding of how the economies of its member countries function, and the interrelationships among them. But its role was widely thought to have been reduced in recent years and, in contrast to that of the Fund, there was little sign as yet of a recovery.

Because it has no money to lend, the OECD has always relied on other means or incentives by which influence could be brought to bear on countries following policies inconsistent with its "internationalist" view of their position and responsibilities. Under Bretton Woods, this was ultimately provided not only by the commitment of most senior policy-makers to the ideal of international cooperation but also by the specific structure of the par-value system. (Indeed, it was not realized in the OECD at the time that success in the movement towards greater flexibility of rates would diminish its role — officials thought they would move to a "managed" exchange rate system).

Under the fixed rate regime, the OECD could analyze the outlook for payments imbalances (and their financing), growth, and employment "with the parameters held in place." If a country was out of line, comments were made, questions raised about the consistency of that country's policies with the "world view" analysis of the secretariat, and often action followed. For instance, following the sterling devaluation of 1967, the WP3 met to hear the UK representative explain the policies the government would follow to make it effective. Other countries with more experience of devaluation than Britain said that these policies would not be enough — and this pressure played a part in Mr. Roy Jenkins' switch to a more deflationary policy.

During this period, the unspoken assumption of fixed exchange rates — which economists were beginning to question — allowed the OECD to mobilize "peer group pressure" on a country out of line, and also gave a central role to the "world view" analysis of the secretariat. Many witnesses told us about the effectiveness of the work of the WP3 in this period. Mr. van Lennep, the present Secretary General, who was then chairman of the WP3, made a habit of writing to finance ministers and central bank governors bringing international considerations to bear on their policies — and they paid attention. The practice died out later. Such discussions became the central focus and vehicle of international policy coordination — while the Fund did the "technical" job of managing the fixed rate system.

But even before the collapse of Bretton Woods, this began to be changed by; (a) the passing of the generation that had run policy in the postwar years — a generation deeply seared by the experience of the 1930s and the lessons drawn from them; (b) the intellectual challenge which gradually replaced the principle that "we're all in the same boat together" with the different principle that "if we all get our policies right at home, the world economy will look after itself" and (c) fundamentally less-manageable economic and political problems, following the end of the golden years of growth, the multiplication of economic issues raised to cabinet-level discussions, and the disillusionment with "fine tuning" and demand management generally.

Increasingly, as officials who attended OECD's meetings could not agree, the focus shifted to ministerial meetings — the Group of Ten, Interim Committee, Group of Five. Meanwhile, the European Community was developing into a focus of regional cooperation — inherently competitive with the OECD/IMF "one world" view — while the NICs were also claiming a place in the system. There were growing problems in gaining agreement on who should be represented at meetings: on the one hand, a smaller group can more easily mobilize "peer group pressure" on a recalcitrant member — on the other, all important interests should be represented, including some smaller countries, which often represent the collective or general interest.

At this stage, according to some observers, the OECD found itself unable to update its intellectual orientation, or develop enough political "feel" and "weight" to establish a role in the new system comparable with that it had played in the old. This failure, as well as institutional rivalries (notably with the EC) prevented it from becoming the secretariat to the summit meetings, which was a logical evolution. Both the OECD and the summits may have lost thereby (though some dismissed the notion that the OECD had any chance of servicing the summits). As a result, the newer structures of cooperation have not been integrated with the older structures, there is no consistent "world view" developed at staff level on which discussions should be based, no adequate preparation and no adequate follow-through:

> "The machinery has evolved in a way that has been destructive of existing institutions, and in a way that is not truly representative. We haven't developed institutions reflecting the 'oligopolistic' power structure of the 1970s-1990s in the place of old US leadership. When we wanted to sell an idea in the old days, we went to Washington and got them to sell it to the others. Now it is much harder."

A list of comments:

a) "The OECD is a great mystery. There is no evidence that it has much impact at all. It is not effective at governmental level — except that some small countries are worried if they get a bad public report. Contact between officials in WP3 does provide a little intellectual lubrication, but OECD is a back-seat driver. However, its able Secretary General has given it a role in the press that another man might not have done".

b) "The OECD has been rather disappointing — it has no real powers but has exercised a restraining influence in holding back protectionism. It has no muscle".

c) "The OECD is valuable as a talking shop, just in keeping industrial countries talking to each other. Because it has no money its main influence was during the fixed rate regime, when it could analyze the outlook for payments imbalances, growth and so on, with the external parameters held in place. It is much harder now for it to be effective with floating and inward-looking policies".

d) "The OECD is much better than the others at economic analysis and presentation, but it is too Keynesian. It does not have enough monetary expertise or knowledge about financial institutions".

e) "The OECD will never regain its old importance because most countries now have better opportunities to meet outside the OECD. Soon it will be nothing more than a meeting place for analysts of the business cycle: it has outlived its usefulness".

The BIS

Both the virtues and the limitations of the "central bankers' club" were mentioned by our respondents. Central bankers have flexibility, because monetary policy can be changed without legislative process; they can move quickly in a "fire brigade" role to raise large sums of money; and above all their deliberations can be kept confidential. On the other hand, often "their hands are tied" — finance and economics ministers, not central bankers, make the strategic decisions. They differ greatly in their degree of independence, though some of the most independent have recently been least innovative. Central bankers have always been conscious of their vulnerability to political and popular criticism. And they have felt the lack of a natural domestic constituency for an "international" view. The answers we received suggested that the cross-currents of the 1970s had highlighted such conflicting aspects of the central bankers' role. In some ways, they were better able to withstand the intellectual challenge of monetarism. But the advent of floating exchange rates tended to reduce their influence. Politicians have criticized them for not monitoring or understanding the international banking system. While they have recently been called upon to mobilize large sums of short-term credit for countries stricken with payments difficulties, shouldn't they have done more to control the mushrooming of the international credit that led to the crisis?

Some quotes:

> "Probably the best of these clubs, within its limits".
> "Its officials were the first to warn officially of the debt problem".
> "It is a Holy-Roman-Empire kind of place for central bankers to meet".

8. Do you favor the strengthening or extension of the multilateral institutions, notably the IMF? If so, in what respects? And do you think such a strengthening to be feasible?

The general view was that the IMF should to be strengthened in terms of resources provided it can make conditionality stick. But there was scepticism about whether its "powers" should be increased. Or, indeed, whether that is feasible. "Only when we have a crisis and we're looking over the edge of an abyss", was the opinion of a former prime minister. Several observed that the IMF does not even use its existing powers.

Two participants said they thought the IMF should borrow from the market. A European central banker said he was against it on the grounds that it would further reduce the liquidity of official claims on the Fund, which he thought was a matter of concern. "If it deteriorates, creditor countries will in time get cold feet. We'll build up big claims on the Fund as part of our reserves; for a central bank it is essential these are liquid and the IMF has to realize this. There is a tendency for the Fund to neglect the importance of this for central banks".

While most participants from the major countries thought the IMF was already expanding in the right direction and all that is needed is to keep it flexible so that it can be continually built on, some views were more visionary. The IMF should think more like a central monetary institution and "not be afraid to talk like one on issues like SDRs and aid-links". More important, "it ought to think more and do more about what is required to make a multicurrency reserve system work. We gave them pointers at Versailles; it could build on these". Another said that it is feasible to strengthen its authority in certain ways, in particular by devising a set of penalties and incentives to persuade countries to go to the Fund at an earlier stage in their payments difficulties.

This view is not inconsistent with that of another respondent formerly close to IMF policymaking, who sees a longer-term need to reform the Fund's structure. "It should be a bank — the whole idea of a 'fund' was only brought in by the Americans to limit their possible exposure, and in fact, the quota limitation is already being eroded". This last reference is to the fact that the IMF now lends up to 450% of a member country's quota under a conditional credit in place of the former 100%. But that 450% figure is only a guideline, not a statutory rule; the IMF executive board is empowered to alter it.

Finally, a key policy maker said he "would not rule out" an attempt to write rules for the system, a process in which the IMF could doubtless play a central role.

With regard to the OECD, a few suggestions for improvement were made. It should have more flexible ways of holding discussions in smaller groups. It should also play a political role as a spokesman for the industrialized countries to the third world and the NICs. A more fundamental suggestion from a European government official was that "if it is really very clever", it should preside over a proper synthesis of Keynesian/Friedmanite principles and their application to a changing world environment. "Where else, on an international scale, could you have discussions on these great issues that divide policy? Not with a lot of LDCs". The role may not seem attractive to people at OECD, who want to strengthen its political prestige and not become "members of a university". Nevertheless, it is an intriguing suggestion, coming from someone who sees the OECD as the "most important international economics institute".

9. Should finance ministers have more frequent meetings? If so, as the Group of Five, the Ten or (bringing in the developing world), the Twenty? Should the IMF and/or OECD be more involved in such meetings?

"For God's sake, no" was a not untypical reaction to the first part of this question. What mattered was the political will to use the meetings constructively, and to divert ministers' attention for a time from purely domestic answers to domestic problems, but respondents differed considerably in their views of the usefulness of the groups and in the extent to which they thought that the IMF and/or OECD could be more involved.

Comments:

> "It is very important to strengthen the Group of Five. I realize this may annoy the OECD, but there it is. The WP3 is too large. We could have more frequent meetings of deputies — we had five in 1981-82, all secret. We normally relied on our own staff work, and can write papers on a personal basis, if necessary".

> "Not meetings, but markets, impose pressure to adjust under Article IV. Surveillance by the Fund needs to be given substance, but it means nothing without a strong G-5 — and that means a bunch of strong finance ministers, including a US spokesman who can speak for the President. Trouble is, there is no respect for each other at present. They can't even keep quiet about the G-5 meetings — a central requirement, otherwise it's all a charade. Unless they can be sure of confidentiality, they will immediately get locked into their negotiating positions — e.g. UK Chancellors are paralyzed by Parliamentary question time" (American observer).

> "There are too many meetings already. We should be much more selective. We must restore the confidentiality of such meetings. The G-5 are the most important — just finance ministers and central bank governors. But it has recently been destroyed by publicity — interviews are given before the participants meet!" (former European prime minister).

> "A good meeting requires agreement on all points before it takes place" (former European prime minister).

> "To hold meetings without results is counterproductive, since they raise doubts that might not have surfaced otherwise. The Interim Committee is useless. The Group of Five is the serious one. OECD could play a role here if it gets a strong political push".

> "The G-5 is the most important of these, but the big countries are not likely to allow the international institutions to play a large role in it. The G-5 is the locus of 'political' or 'ad hoc' cooperation. As the United States is ready for that again, we could even see a move towards an understanding between the US and the EC on target zones for exchange rates. We always wanted the EC to have a common policy with regard to the dollar, but we need US agreement for that".

> "Both the IMF and the OECD should be involved in G-5 meetings, so that they are better prepared and have a better follow-up" (former international financial official).

> "The Group of Ten has worked well; it negotiated SDRs, and had some good discussions — the role of smaller countries is usually constructive, because it is in their interests to get agreement among the major powers".

> "The fact of life is that the G-5 countries are more dominating and unanimous in their objectives than ever before, so it is very important that they should seek to agree on their policies. But you have to be cynical about how much will come out of the experiment of asking the MD of the Fund to attend. It was given to the Fund rather than the OECD because of the more conservative stance of its policies".

> "The Group of Ten has always been awkward. Why should the US go to meetings to be attacked by Belgium and Switzerland?".

> "When the big countries meet alone — e.g. as the G-5 — they very rarely criticize each other, or attempt to formulate a view of the international interest. They are much keener to make trade-offs between each other".

> "If the Group of Five doesn't work, larger groups won't".

> "The trouble is that four out of the Group of Five never take the initiative. France, Britain, Germany and Japan moan all the time about US policies, but they have never come up with a constructive idea and have never put real pressure on the United States. Their behavior is rather childish" (central banker).

> "If you have a lot of international bureaucrats at these meetings, the meetings take on a different function. It is quite useful, however, to have the IMF helping to control the agenda for the G-5" (finance ministry official).

> "Ministers meet far too often — they don't have any time to sit back and think" (former European prime minister).

10. In your judgment, is there evidence that the greater degree of monetary and economic cooperation aimed at within the European Community has had positive results in practice?

There was a striking difference of view between those from countries whose currencies are not members of the EMS, who said the EMS was irrelevant or at best marginally positive, and those from member countries, who were enthusiastic.

Most respondents would probably agree with the international official who said:

> "It is providing a useful test-bed for a managed adjustable peg system, but it could be blown apart, which would give ammunition to those who always said it wouldn't work. It was misguided to try to use fixity to impose greater convergence of policies than was possible. But it has gradually moved to striking a realistic balance between relatively marginal adjustment of national policies with the necessary recognition of reality in terms of adjusting exchange rates".

Another official observed that policies in all member countries now take account of their EMS obligations, and decisions about central rates have become fully collective (i.e. they are decisions of the Council of Ministers, prepared by the Monetary Committee).

It was also said that the Commission is freer to take positions in public about policies of member countries than can the Fund or OECD. But others said that the Commission was generally even worse than the Fund in its absorption with its institutional mysteries, one reason perhaps for the alleged neglect of EC monetary affairs by the Anglo-Saxon press.

11. What place has summitry in international cooperation? How could economic summits of heads of state be made more useful?

Summits were regarded as inevitable but the quality of the input and output as poor. While they could be useful in "setting artificial deadlines" for policy decisions, and "mobilizing domestic support for unpopular policies", they also sometimes delayed decisions that would have been taken at lower levels if people hadn't been able to say "wait for the summit". Some felt they should be institutionalized, with better staff work and papers, and follow-through, but many others said they should be as informal as possible (the ideal being "a quiet weekend chat", which the host country *could* insist on, if it wished) and that they were the place for ideas rather than decisions. For instance, if exchange rates were to be the focus of attempts to coordinate policies better, this involved a mass of issues relating to fiscal and monetary policy which summit meetings were not equipped to settle. Most regretted the blaze of publicity that surrounds them — "ridiculous theatre". However inevitable, that was just one more reason for their inability to serve as useful places for decision-making.

Forums of International Cooperation

There are many established forums for discussing international monetary and economic problems at ministerial and official levels.

In the 1950s and early 1960s the most important discussions on current economic developments generally took place in the OEEC/OECD and the BIS. During the 1960s, the **Group of Ten**, whose members are finance ministers and central bank governors of the major industrial countries, became increasingly important. In 1963 this group — the so-called rich man's club — began to hold regular meetings dealing mainly with international monetary reform thereby treading somewhat on the toes of the executive directors of the IMF.

The Group of Ten went out of favor with the Americans after the ill-fated Smithsonian meeting in December, 1971, which marked the attempt to refix exchange rates that was to fail so quickly: in the early 1970s the IMF's **Committee of Twenty**, deliberating a grand design of international monetary reform, seemed to have taken over from the Group of Ten. But that committee's work was torpedoed by the oil crisis and it had to admit defeat in 1974. However, some of the Group of Ten's former role has been taken over by the IMF's ministerial-level **Interim Committee**, which has 22 members, about half from developing countries, and has met twice a year since October, 1974.

The Group of Ten has also been somewhat eclipsed by a still more exclusive club. The Interim Committee is cumbersome and bargaining is reckoned to be best done within the smallest possible power group. From the time of the 1973 IMF annual meeting in Nairobi, the most important forum has become the **Group of Five**, consisting of finance ministers from the United States, Japan, Britain, France and Germany. This inner group met once again in 1973 after the Nairobi meeting, at the invitation of Giscard d'Estaing (then France's finance minister) and has met frequently since, regularly during IMF meetings but at other times also.

It was from these Group of Five ministerial meetings that the idea of annual **economic summits** evolved, the first being held at Rambouillet in November, 1975, at the invitation of Giscard d'Estaing (by then France's president), when six heads of government met, Italy having been added to the five. Canada has been included too since 1976.

Summits

1. Rambouillet, November 15-17, 1975

Six heads of government (United States, Japan, Britain, France, Germany and Italy) attended. There was a Franco-American agreement on exchange rates. France gave up its insistence that new IMF articles must provide for the eventual reestablishment of fixed parities. The United States agreed that "our monetary authorities will act to counter disorderly market conditions or erratic fluctuations in exchange rates". It subsequently became clear, however, that the United States was taking a narrow interpretation of the clause and had not really committed itself to more forceful intervention in the exchange markets.

2. Puerto Rico, June 27-28, 1976

Canada joined the six, making the first seven-power summit. Criticisms from Italy and Canada about being excluded from Group of Five meetings. The summiteers agreed risks would be taken by the stronger economies in allowing quite high unemployment if that was reckoned necessary to keep prices in check.

3. London, May 7-8, 1977

European community represented for the first time (by Roy Jenkins). President Carter's first overseas visit after his inauguration. The statesmen committed themselves to seek additional resources for the IMF. They also promised to stick to their own growth targets and take action if they began to fall short. But the strong countries (United States, West Germany, Japan) did not promise any specific new stimulatory action.

4. Bonn, July 16-17, 1978

Declaration of the "locomotive theory", with West Germany and Japan becoming the locomotives to help pull up expansion in the industrial world. The West German delegation (led by Helmut Schmidt) indicated that by end-August it would propose legislative measures to add up to 1 percent to GNP. And the Prime Minister of Japan gave assurances that measures would be taken as necessary to achieve Japan's real growth target for fiscal 1978, which was about 1.5 percentage points higher than in the previous year.

5. Tokyo, June 28-29, 1979

Focused on energy, after the second oil shock. Wrangling over oil import ceilings.

6. Venice, June 22-23, 1980

Largely platitudes. Private lending to oil-importing developing countries will need to be supplemented by an expanded role for international institutions, especially the IMF. Continued close cooperation in exchange-market policies so as to avoid disorderly exchange-rate fluctuations. "We will also cooperate with the IMF to achieve more effective surveillance".

7. Ottawa, July 19-21, 1981

Specific issue: American interest rates, which were seen by West European governments as resulting in severe pressure on their currencies in relation to the dollar, and also as representing a major obstacle to recovery from the world recession.

8. Versailles, June 5-6, 1982

Great expectations were built up before this summit that some coordinated action would be taken by the western leaders to counter both recession and exchange-rate volatility. The communiqué was bland. The Americans promised to "counter disorderly conditions" in the exchange markets, but they had said that before. All that was new from the Americans was a promise of an international study on intervention.

9. Williamsburg, May 28-30, 1983

The vague reassurances about cooperation made at Versailles were repeated. Coordinated intervention in the foreign exchanges was promised where "it is agreed that such intervention would be helpful". This left the main thrust of intervention still confined to countering disorderly markets. In a concession to the French, finance ministers were told to define, in consultation with the IMF's managing director, conditions for improving the international monetary system and to consider the possibility, "in due course", of a high-level international monetary conference. There was also talk about a full-fledged negotiating round in the GATT.

IMF (International Monetary Fund)

Established at the Bretton Woods (New Hampshire) conference in 1944, the IMF was envisaged as an organisation that would ensure a stable world financial system and monitor a system of fixed exchange rates. The World Bank was set up at the same time to help in development assistance.

Both are specialized agencies of the United Nations.

Nearly 40 years ago, it was never conceived that gold or the dollar would be challenged as reserve assets. The founders of the IMF — 45 nations, led by the United States and Britain — were concerned to prevent a repetition of the beggar-my-neighbor trade policies of the 1930s, when countries resorted to competitive currency depreciations in their efforts to solve unemployment problems. Each IMF member, therefore, was obliged to establish a par value for its currency in terms of gold and change it only after having secured IMF approval, given only if the country's balance of payments was in "fundamental disequilibrium." Meantime, the IMF stood ready to lend, under certain conditions, to member countries in temporary balance-of-payments deficits. Clearly the IMF did not intend exchange-rate adjustments to be taken lightly.

The world's monetary system has changed radically since then. The system of fixed exchange rates has long broken down and gold has disappeared from the center of the stage. When the system of pegged rates finally collapsed in 1973, it looked as if the IMF was out of a job. And so it might have been had it not been for the shocks produced by OPEC's oil price rise in October, 1973. The IMF quickly saw the need to recycle funds from the surplus countries to the deficit countries to help them meet the high cost of their oil imports, and it launched new mechanisms to do this — the so-called oil and Witteveen facilities.

Since then, increasing calls have been made on the IMF's resources by cash-starved and debt-ridden countries, most recently by major Latin-American countries. The IMF is lending more than ever before to more countries and it now has 146 members. It is thus increasing its influence on the domestic economic policies of member states, since countries can only borrow from it — beyond comparatively small amounts — if they agree to implement approved programs of economic reform. And commercial banks, forced to reschedule their huge loans to many developing countries unable to meet their obligations, are also insisting these debtor countries accept IMF programs before they can hope for much-needed new bank credit. Indeed, banks are increasingly reluctant to take any sovereign risk unless the IMF is monitoring the country's economic progress. So the IMF has now a central role to play in keeping the world economy going and preventing the financial system from breaking down. But it can only do this if it has enough money to make conditional loans.

For most of its lifetime the IMF has worried about a shortage of resources. It relies basically on its quota subscriptions; these now total about $94 billion, but only about half are in currencies that are acceptable internationally and which therefore the IMF can on-lend. More than 20 years ago, the IMF reflected what would happen if its largest member, the United States, sought to borrow heavily from it; in November, 1961, for example, the United States had a potential right to borrow $5.8 billion from the IMF, but the IMF's holdings of usable currencies at the time amounted to only about $1.5 billion.

So the **GAB (General Arrangements to Borrow)** came into being in 1962 after a series of involved negotiations. Ten countries (the United States, West Germany, France, Britain, Italy, Japan, Canada, the Netherlands, Belgium and Sweden) agreed to stand ready to lend $6 billion between them in their national currencies to the IMF, for on-lending to each other. Later Switzerland, not an IMF member, associated itself with the arrangements.

The **Group of Ten (G-10)**, as these countries are referred to, form an exclusive club. It always meets at the times of the IMF annual meeting and the spring interim committee meeting, usually at both deputy and ministerial level. The deputies of the G-10 finance ministers are charged to keep each other informed about balance-of-payments developments that could give rise to the use of the GAB. And along with OECD's Working Party 3, the G-10 deputies have played an important role in international monetary initiatives in the past 20 years.

In the early 1960s international liquidy was not keeping up with the expansion in world trade and output. Ministers and IMF governors of the G-10, therefore, at the IMF annual meeting in 1963 told their deputies to examine the probable future liquidity needs. The deputies reported that there might in time be need for some kind of reserve asset which would be additional to gold and the dollar. A study group was set up under the Bank of Italy's Rinaldo Ossola to examine various proposals for the creation of reserve assets. Its report was published in August, 1965; it envisaged the deliberate creation of reserve assets through IMF units or drawing rights, but did not make specific recommendations. The deputies, under the chairmanship of the Bundesbank's Otmar Emminger, then examined various proposals and held joint meetings with the IMF executive directors throughout 1966 and 1967. Eventually and after much wrangling — with France for a long time opposing the idea — finance ministers of the G-10 agreed in August, 1967, the outline of a contingency plan for the IMF to create **Special Drawing Rights (SDRs)**, that is to say, to create unconditional liquidity out of thin air.

The SDR was actually established in 1969, under the first amendment of the IMF's articles. Its value was originally defined in terms of gold, but it is now defined as a weighted basket of currencies — the dollar, DM, sterling French franc and Japanese yen. The first allocation was made on January

1, 1970, and the total stock of SDRs now stands at SDR21 billion, distributed as follows:

First basic period	1970-72 : SDR3 billion a year
Second " "	1973-78 : Nil
Third " "	1979-81 : SDR4 billion a year

During the period of the first three-year allocation of SDRs the whole basis of the international monetary system was changed by President Richard Nixon's decision on August 15, 1971, to sever the dollar's link with gold. Four months of uncertainty followed, with the G-10 meeting several times at deputy and ministerial level. The OECD's Working Party 3 tried to assess the scale of the adjustment required in America's balance-of-payments but failed to reach agreement. Finally, the G-10 ministers met at the Smithsonian Institution in Washington on December 17th. The **Smithsonian Agreement** provided a new set of fixed parities, but with wider temporary margins — 2.25 percent above and below parity — than in the Bretton Woods system. The dollar remained inconvertible.

The Smithsonian realignment was never realistic. Foreign exchange markets were nervous almost immediately afterwards. By June, 1972, the pound was under pressure and was floated "temporarily." In February, 1973, there was a second devaluation of the dollar, this time by 10%; by then the yen, Swiss franc, Italian lira and the Canadian dollar had joined sterling in floating. By March that year there was generalized floating.

Meantime, in the spring of 1972, agreement had been reached to establish a committee of the board of governors of the IMF on reform of the international monetary system and related issues — which became known as the **Committee of Twenty**. At ministerial level, the committee was composed of finance ministers and central bank governors; at deputy level by senior officials of finance ministries and central banks (in some cases, governors of central banks). Jeremy Morse (now Sir Jeremy Morse) was chairman of the deputies and a fulltime executive of a small bureau. The issues for the Committee of Twenty were: (1) balance of payments imbalances; (2) settlement of payments imbalances; (3) volume and composition of international reserves; and (4) special problems of developing countries. The committee produced an "outline of reform," but by then the uncertainties caused by widespread floating and the first oil shock made other problems more immediate and the committee was disbanded.

However, as provided for in the outline of reform, the governors of the IMF established in 1974 an **Interim Committee** similar in form to the Committee of Twenty. It acts only in an advisory capacity to the board of governors, but in practice its proposals are always adopted. The 22-member committee is described as "interim," because the IMF's new articles of agreement (revised for the second time in 1978) envisage a permanent and representative decision-making council. This council has not yet been established.

The interim committee meets twice a year. Two of its meetings so far have been particularly significant. The first was in Kingston, Jamaica, on January 7-8, 1976, when agreement was reached in principle on a new set of IMF rules — which were formally ratified just over two years later, in April, 1978. The main changes were: (1) Official price of gold was abolished; (2) Floating of exchange rates was legalized and under "Article IV," which sets out exchange rate arrangements, the IMF was given "firm surveillance" over exchange rates; (3) Higher quotas came into force; and (4) Use of SDRs was widened.

The second meeting was in Washington on February 10-11, 1983, when agreement, subject to ratification by member states, was reached to increase the total of IMF quotas from SDR 61 billion to SDR 90 billion and to endorse the Group of Ten's earlier decision to increase commitments under the GAB from SDR 6 1/2 billion to SDR 17 billion and make this enlarged amount available for on-lending to non-G-10 countries "if this is required because of a threat to the stability of the international monetary system." Switzerland has since become a full member of the G-10. Also Saudi Arabia is to be associated with the GAB and is prepared to contribute SDR 1.5 billion.

OECD (Organisation for Economic Cooperation and Development).

Founded in September, 1961, the OECD replaced the 13-year-old Organisation for European Economic Cooperation, a by-product of Marshall Aid, after President John F. Kennedy had proposed American membership. Today it has 24 members, all industrial countries; its non-European members are, besides the United States, Australia, Canada, Japan and New Zealand.

The general objective of OECD is to facilitate intergovernmental cooperation on questions of common interest to policy-makers throughout the OECD area. The secretariat today numbers about 1,800 of whom a third are classified as professional staff. About half of the 163 posts in the department of economics and statistics are professional.

OECD's governing body is the Council, on which each member country is represented. This meets regularly, with the heads of national delegations carrying the rank of ambassador; and from time to time, usually once a year, at ministerial level.

The greater part of OECD's work is carried out in its specialized committees and working parties which number more than 200. These committees are usually composed of senior officials from permanent national delegations to the OECD and are serviced by the secretariat. Two of these are particularly important to this study: the Economic Policy Committee (EPC) and Working Party 3.

The **Economic Policy Committee (EPC)** usually meets twice a year, in May or June and again in November, to discuss issues of economic management, both shorter-and-longer-term. Its members are senior officials from the ministries of finance or economics and from the central banks of each member country. Shortly before the EPC meetings a working group of EPC on short-term prospects discusses the secretariat's integrated economic forecasts, which are then presented to the EPC meeting. The discussions concentrate on the main macroeconomic policy issues, and have tended to foreshadow what has subsequently come out of OECD ministerial meetings on these issues. The secretariat's analyses and forecasts, as amended in the light of these discussions, are published in the July and December issues of the OECD Economic Outlook. Present chairman: Martin Feldstein, Chairman of America's Council of Economic Advisers.

Working Party 3, a specialized group of the EPC, is concerned with the impact of economic policies on the international payments and monetary situation, with the adjustment and financing of payments imbalances, and with the likely evolution of exchange rates and payments imbalances. It usually meets about five times a year. Membership is confined to the 10 largest OECD countries (the Group of 10 minus Belgium plus Switzerland) and members are senior officials from finance ministries (and similar agencies) and central banks of these countries. It is the main forum in which monetary and balance-of-payments problems and policies of the larger countries are examined, compared and debated. In the early 1960s it was the forum in which European criticisms of the American balance-of-payments deficit were aired. In recent years it has discussed problems arising from the development of a multicurrency reserve system, potential for extending the role of official institutions in recycling and the interactions between interest-rate variability, exchange-rate pressures and techniques of monetary control. Present chairman: Christopher McMahon, Deputy Governor of the Bank of England. Earlier chairmen: Emile van Lennep (then Treasurer-General of the Netherlands), Otmar Emminger (then Vice President of the West German Bundesbank), and Michiya Matsukawa (then Vice Minister at the Ministry of Finance, Japan).

The European Community (EC)

The European Community was established in January, 1958, with an original membership of six — Belgium, France, West Germany, Italy, Luxembourg and the Netherlands. It has since been expanded to ten, with the accession of Britain, Denmark and Ireland in 1973 and of Greece in 1981.

The **Monetary Committee**, which was set up in 1958, and the **Committee of Governors of the Central Banks**, which came into being in 1964, are the specialist bodies responsible for coordinating monetary policy within the Community. There is also the *Short-Term Economic Policy Committee* established in 1960 and since 1964 the *Budgetary Policy Committee*.

The Community's rulebook is the Treaty of Rome (signed on March 25, 1957). This was an original formula for the creation of an economic community which had no precedent in history. The Treaty contains detailed provisions for the organisation of the common market (free movements of goods, workers and capital), as well as a number of arrangements laying the foundation for economic union.

However, the Treaty confines itself to generalities when it comes to coordination of economic policies. Two documents on the subject became of prime importance: the Barre plan of February, 1969, and the Werner report of October, 1970.

The Barre plan (Raymond Barre, who subsequently became France's prime minister, was then the EC commissioner in charge of economic and financial affairs) contained detailed suggestions for concerted action. National medium-term objectives must be converged, Barre said, the main targets being related to growth rates in production and employment, price trends and the balance of payments. There must be concerted short-term economic policies within the medium-term framework and machinery should be set up for monetary cooperation.

The task of a group of experts, chaired by the then Prime Minister and Minister for Finance of Luxembourg, Pierre Werner, was to study ways of implementing these suggestions step by step. Werner's dilemma was to reconcile two opposing views. Monetarists told him exchange rates should be tied together first and economic unifications should come afterwards. Economists told him the European economies must be converged together first and only after that could exchange rates be bought together.

The Werner committee advised a compromise — progress on both fronts simultaneously. Cooperation in budget, monetary and regional policies was to go ahead in stages. At the same time margins of fluctuations in exchange rates were to be narrowed progressively until ultimately national currencies were replaced by a single European currency. European monetary union in its full sense was to be achieved by 1980. Fulfillment of these conditions would require the establishment of (1) a single decision-making center for economic policy, responsible to the European parliament; and (2) a community system of central banks.

Member states accepted the essentials of the Werner plan in February, 1971, with the narrowing of exchange-rate margins due to start in June, 1971. Even that move was postponed; faced with dollar weakness and currency upheavals in May, 1971, EC countries were unable to agree on a concerted policy. Then the Smithsonian agreement in December, 1971, widened rather than narrowed currency margins.

Nevertheless, the proposed narrowing of intra-community exchange rates came into being for the original six members in March, 1972: the maximum spread between any two member countries' currencies was set at 2.25 percent. But the joint European float — the *European snake* as it was known — was never a strong creature. The other EC members (Britain, Denmark and Ireland) joined in May, 1972, but defected in June, when sterling was floated, although Denmark rejoined in October, 1972. Italy remained in during that time only because it was given special inducement to do so and even that did not prevent its departure beyond February, 1973. France left in January, 1974, rejoined in July, 1975, but left again in March, 1976. On the other hand, two non-EC countries joined: Norway from May, 1972 to December, 1978, and Sweden from March, 1973, to August 1977. When it came in 1979 to turning the snake into a supersnake, i.e., the **European Monetary System (EMS)** the only remaining members were West Germany, Denmark and the Benelux countries.

The EMS differs from the snake it replaced in several ways:

1. Two major currencies, the French franc and Italian lira, came back into the system. Ireland, too, joined. Only sterling stayed out.
2. There is increased credit backing to support intervention.
3. The European Currency Unit (ECU) has been assigned new functions. Although it is still primarily an accounting instrument, central banks in the EMS can use ECUs for official settlements. So it is possible the ECU will develop as an infant European currency.
4. One-fifth of EC countries' reserves are now pooled, although for the time being there is no formal change of ownership — i.e., the reserves are only "lent".

At the end of two years of EMS, that is by March, 1981, the EC countries were supposed to introduce its second phase. That would have involved developing the ECU as a more convincing reserve currency and creating a European Monetary Fund (EMF), in place of the present **Euro-**

pean Monetary Cooperation Fund, which was expected to develop as a kind of European IMF. Countries would have genuinely pooled some of the reserves, depositing them with the EMF, and the EMF would have been responsible for all short-term and medium-term EC loans, as well as "conditional" credit-lines.

In fact, that second stage was postponed and no new date has been set for it. In the first four years of the EMS, there were seven realignments of currencies. It seems, therefore, that the EMS marked a step forward, but has yet to stand the test of time. Werner's goals have certainly not been achieved.

BIS (Bank for International Settlements)

The BIS, situated in Basle, Switzerland, is a bank for other central banks, able to do all types of banking business but with a clientele limited to central banks, especially those in Western Europe and North America. It was set up in 1930 to help organize German reparations. Its founders were leading Western central banks, not governments (though the governments signed the convention which gave the BIS special status). After a promising start, the banking business languished as a result of the 1931 financial collapse and did not pick up until the 1950s.

The BIS first came into its own in the late 1940s and early 1950s when it acted as an agent for the Intra-European Payments Agreements and then for the European Payments Union, a financial clearing arrangement between European countries.

In the 1960s it initiated new forms of international cooperation. The prototype Basle operation was provoked (as was the establishment of the Federal Reserve swap network) by the speculative capital flows that followed the 5 percent revaluation of the DM in March, 1961. At the end of Europe's most chaotic currency week since the second world war, the central bankers gathered in Basle (from Britain, Belgium, France, Italy, the Netherlands, Sweden, Switzerland and West Germany) announced they were cooperating closely in the exchange markets, and "no party to the so-called **Basle Agreement** should be forced by speculative movements of funds to deviate from the declared policy". The central banks stood ready in an informal way to help each other defend the parities of their currencies in two ways: (1) by three-month credits or swaps, e.g. if speculators switched dollars from London to Switzerland and these landed up in the Swiss central bank, the Swiss central bank would re-lend these dollars to the Bank of England, in the form of a three-month dollar deposit; or (2) if a foreign central bank started accumulating sterling because of a run on the pound it would simply hold it for three or six months and refrain from converting it, so deadening the impact of the withdrawal on Britain's exchange reserves. Not only did the BIS provide the forum for these Basle arrangements, but it also participated as a principal in most of them.

Official swap credits in a reciprocal bilateral network were also developed by the American authorities from 1961 onwards. The **Federal Reserve swap lines** with other central banks (11 in today's arrangements) provide for the Federal Reserve and the foreign central bank to exchange each other's currencies up to a maximum amount for an agreed period of three or six months, after which the transaction is reversed unless it is renewed (as it was frequently in the early days). The BIS also participates in this network on its own account.

In the 1960s Britain made most use of these short-term central bank credits, though France, Canada and Italy also had recourse to them. To begin with, Britain's use of these credits were either self-reversing or refinanced with other credits. Thus in 1961 Britain repaid $900 million from the central banks out of the proceeds of a $1.5 billion IMF drawing. But as sterling came under increasing pressure, the central bankers found themselves putting together special packages for Britain, such as the $3 billion short-term support package of November, 1964. Again Britain was able to repay when a longer-term arrangement was made in 1964 with the IMF.

Until 1966 the system of central bank cooperation had provided unconditional support for sterling. Then came two longer-term **Basle Group Arrangements** for Britain, to relieve it of the strains arising from sterling's role as a reserve currency. The first, negotiated in June, 1966 (renewed in March, 1967 and March 1968), assured Britain of a credit line of up to $1 billion provided the pressures on the pound arose from fluctuations in the official sterling balances held in London and not from Britain's balance of payments. The second, in 1968, involved more explicit conditions: Britain could make use of a $2 billion medium-term facility provided agreements were negotiated with sterling area countries whereby they undertook to hold a specified proportion of their reserves in sterling in return for a dollar-value guarantee. Some commentators saw this as a turning point at which monetary diplomacy became visibly politicized.

Central bank cooperation to help industrial countries did not stop in the 1960s. Britain and France relied heavily on it in the mid-1970s, though they were also at the time drawing on IMF credit. Britain, for instance, obtained a three-month $5.3 billion credit on June 7, 1976, from the central banks of the Group of Ten countries, together with Switzerland and the BIS, which was rolled over for another three months on September 7th.

Short-term lending to central banks is a traditional part of BIS business. But more recently, it has moved into a new field, providing prefinancing of IMF deals, acting as a joint supplier with central banks. Providing such finance for three to six months for Hungary, Mexico, Brazil and Yugoslavia represented the BIS's first sorties into this kind of lending.

From 1960 onwards European bankers felt that Federal Reserve participation in their monthly meetings was essential, even though the Federal Reserve had never picked up the BIS stock initially allotted to it and its attendance could be only in an observer capacity. Today governors of the central banks of the Group of Ten countries and Switzerland meet in the second weekend of 10 months of the year. The BIS also organizes periodic meetings of central-bank officials to examine matters such as the development of the gold and foreign exchange markets and the Eurocurrency market.

The BIS also provides the secretariat for the Committee on Banking Regulations and Supervisory Practices, which was established by the Group of Ten central banks in December, 1974. (This is now chaired by the Bank of England's Peter Cooke). It does likewise for the Committee of Governors of the EC central banks and for the Board of Governors of the European Monetary Cooperation Fund, for which it acts as agent. There is a standing committee systematically monitoring international developments; this meets quarterly.

The BIS has a large data bank designed to meet the needs of central banks and it is the main source of data on the Eurocurrency market.

GATT (General Agreement on Tariffs and Trade)

An international treaty signed in 1947 by 23 countries in order to set up an international trade organization and direct policies towards the reduction of trade barriers. Based in Geneva, the GATT is a specialized United Nations agency and there are now 87 contracting parties, with a further 31 countries applying GATT rules *de facto*.

When the **Kennedy Round** started in 1963, five multilateral tariff negotiations had already been conducted under the GATT since the second world war. This operation, prompted by President Kennedy's trade expansion act of 1962, was the most ambitious tariff-cutting exercise ever attempted. Negotiations lasted until mid-1967 and resulted in tariff cuts averaging over 35 percent on industrial products, and 50 percent or more on some items.

Another assault on trade barriers, the **Tokyo Round**, began in September, 1973 and ended in November, 1979. This time the tariff cuts, spread over eight years, were less significant than in the Kennedy Round, though for some individual items they were important — for instance, America's tariff on high-class woollen textiles was slated to come down from 44 percent to 33 percent. Some important codes were decided: one to prevent trade being hindered by technical standards and import licensing procedures; another to open up non-military government procurement to foreign competition.

International cooperation — a personal view

by Otmar Emminger

Dr. Otmar Emminger draws on his long experience in the field of international finance to provide the following personal view on monetary cooperation during the past quarter of a century.

1. Monetary cooperation in the Bretton Woods period up to 1973 was relatively good as long as it was easy to follow in the footsteps of the almighty dollar, which was pretty stable in terms of prices until the second half of the 1960s, and at the same time provided the rest of the world with ample gold and foreign exchange reserves. Already at that time, however, there were violent criticisms of each other's *non-cooperative* policies — e.g. Giscard d'Estaing's attack against the US at the IMF's Annual Meeting in Tokyo 1964 for their alleged flooding of the world with (inflationary) dollars, or the American attacks, in the first half of the 1960s, against the Europeans for disturbing the international equilibrium by inadequate capital market development. There were the attacks of de Gaulle on the dollar as a reserve currency, and in favor of a gold-based system, and the breakdown of the Gold Pool in 1968.

2. This is even more to the point; there was no real international cooperation with regard to the major currency adjustments. The French did it in 1957 without any prior warning; there was only cooperation afterwards when both the EPU and the IMF had to provide special loans (I participated in both negotiations). West Germany upvalued the DM in March 1961 without even consulting the IMF; the then Managing Director of IMF, Per Jacobsson, expressed his violent opposition, of which I got my share when I was sent to Washington by our government and the Bundesbank to broach him the news of the decision already made. The EC was so upset by the complete lack of previous information on the DM upvaluation, that in the EC Monetary Committee we had to work out an obligatory information pro-

cedure for similar cases in the future. Thus, when the British devaluation of November 1967 arrived, we had at least some preparatory discussions (in Basle and in a small group of leading officials in Paris, but only in the 8 days before the event) on the magnitude of the devaluation (up to which the others pledged to hold still with their own parities). I clearly remember that even at the time of the Fund's Annual Meeting in Rio in September 1967 it had been impossible to have a real talk on the pound's adjustment in a confidential group, even though the events pointed to a parity change sooner or later (there was some discussion between the British and the Fund's staff without information to the other countries).

3. The first real monetary "cooperation" came in the wake of the DM upvaluation in March 1961; its repercussion on the pound sterling led to the first Basle central bank swap credit for the Bank of England and also speeded up the establishment of the Federal Reserve's international swap network. In the 1960s there were several ad hoc central bank loan operations for the Bank of England, which were praised as good international cooperation (but criticized by others). The Gold Pool of the Basle central banks from 1961 to 1968 was also a well-meant piece of international cooperation in defense of the dollar; it was even reasonably successful up to 1965, but thereafter was doomed to failure by changed circumstances.

4. Such "cooperative actions" happened, of course, also after 1973, and some were more spectacular and much more successful, e.g. the huge 6 months' central bank loan of over $5 billion to the Bank of England in June 1976, which deliberately and in a well-planned fashion, paved the way for the British IMF drawing of December 1976 — the turning point for the pound sterling in the 1970s; or the concerted action for the US dollar in November 1978, etc. etc.

5. Of particular interest is the history of the last two years before the final breakdown of the fixed-rate system. The suspension of the dollar's gold convertibility in August 1971 (with all its attendant measures) was not discussed with any of the other interested parties. We were informed afterwards by a telephone call from the White House, and the next day by Paul Volcker in London. Only thereafter began a real discussion and negotiation over many months, leading to the Smithsonian Agreement of December 1971. But we could not complain; when West Germany went into temporary floating in May 1971, circumstances forced us also to inform our partners only after the event.

6. After the transition to floating, or rather from 1972 onwards, there was much more international discussion on monetary matters, including both domestic policies and exchange rates, than ever before. One reason was that in the EC the new European monetary arrangements, i.e. the

block-floating against the dollar, as well as the occasional exchange rate adjustments in the "Snake" and in the "EMS", inevitably led to continuous discussion and negotiation. The new European system made actual negotiation on each currency adjustment *de rigueur* — very much in contrast to the Bretton Woods era where no such open negotiation among the partner countries existed, with the exception of the Smithsonian Arrangement which was itself necessitated by unilateral action of the US (and West Germany).

7. Not only were parity adjustments different after 1973, but also discussions on other monetary matters assumed a different character. This was in part due to the fact that after 1973 the highly sensitive matter of exchange rate parities no longer blocked discussions on general policies. Moreover, a number of new high-level bodies — the Group of Seven (leading to the Summits), the Group of Ten, later the Group of Five — provided more effective and (mostly) confidential meeting grounds. On top of that, there were numerous ministerial and central bank governors meetings in the EC which in the 1970s talked incomparably more also on monetary and financial policies of member countries than before the 1970s. The OECD, too, became in the 1970s a more active forum for discussion and occasionally for policy coordination, in particular for cooperation against protectionism. There cannot be the slightest doubt that the machinery (or the mechanism) for international cooperation is markedly better today, as compared to the period before 1973.

8. Occasion for cooperative action was also provided by the oil price shocks, which — among other things — brought the IMF into focus, with its cooperative actions together with the central banks of the stronger countries etc. Kissinger's attempt at setting up a major "cooperation" in the form of a battle fund failed. But the International Energy Agency should not be overlooked as a platform for economic cooperation.

9. The international action on the occasion of the debt crisis is, of course, the most spectacular example of monetary and financial cooperation. Even if it should not prove a full success, it certainly showed a more cooperative spirit than most people would have expected beforehand. But even apart from this recent, very outstanding, example, the conclusion is justified that after 1973 there was not less, but equal or more, international cooperation on many monetary and economic matters.

10. It is, however, true that in some ways the year 1973 has been a dividing line *as concerns the character of international monetary cooperation*.

First, the introduction of monetarism in reaction to the high inflation of the early 1970s has inevitably strengthened an introverted attitude in monetary matters. Second, the goals of monetary cooperation have changed, as compared with the preceding period, in as much as, at least between the major currencies, the maintenance or attainment of a fixed exchange rate was no longer a direct goal (although the evolution of the floating rate has remained an important consideration for monetary policy in most countries.). The emphasis of monetary policy has shifted towards domestic stability, a matter of sheer self-defense against the worldwide inflation of the 1970s. It is, however, remarkable that in the end the concentration on the fight against inflation has produced, among a "stability group" of countries which comprise over half of the world economy, *a better convergence and lower inflation rates than in the last years of the decaying Bretton Woods system*. Thus there was no breakdown, but a strenghtening of monetary discipline under the floating rate system, while the fixed, but adjustable rates under the EMS have not been able to produce a similar result.

11. It is also true that in some respects there has been a deterioration in international cooperation since 1980/81 and this is mainly due to two reasons:

- — The recession and the distortion of major exchange rates (dollar, yen) have provoked strong protectionist pressures.
- — There has been a shift away from multilateralism, under the Reagan administration, especially as concerns international institutions.

12. Apart from the last point mentioned in the preceding paragraph, it could be said:

a) that the nature of cooperation, and more generally the nature and goals of economic and monetary policy altogether, have changed in accordance with changed circumstances, e.g. the changed position of the dollar, the transition to wide-spread floating, the attack from worldwide inflation, fostered also by the oil price shocks, the recession, exchange rate distortions etc.,
b) that the will toward good cooperation has not declined at all, especially among the monetary authorities,
c) that in some ways the position of monetary policy, and with it that of monetary authorities, has been generally strengthened, as compared with the 1960s,
d) that international economic interdependence has continually increased, and that this has, on the whole, been recognized and appropriate action taken,
e) that the available machinery for international cooperation is much more elaborate and refined than, say, in the 1960s and early 1970s.

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Address inquires to:
The Group of Thirty
725 Park Avenue
New York, New York 10021